

Principles of

Accounting

Volume 1

Financial Accounting

Principles of Accounting, Volume 1: Financial Accounting

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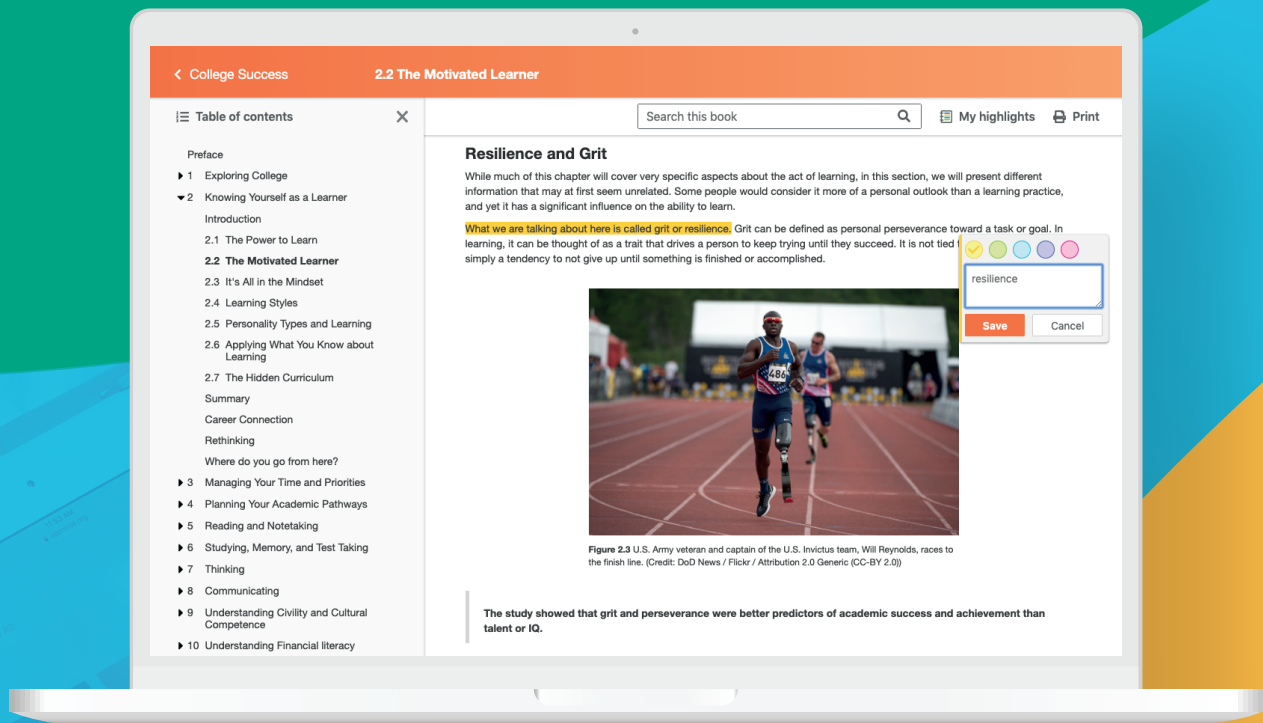


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TABLE OF CONTENTS

Preface 1

1 Role of Accounting in Society 11

- 1.1 Explain the Importance of Accounting and Distinguish between Financial and Managerial Accounting 12
- 1.2 Identify Users of Accounting Information and How They Apply Information 14
- 1.3 Describe Typical Accounting Activities and the Role Accountants Play in Identifying, Recording, and Reporting Financial Activities 18
- 1.4 Explain Why Accounting Is Important to Business Stakeholders 24
- 1.5 Describe the Varied Career Paths Open to Individuals with an Accounting Education 32

2 Introduction to Financial Statements 61

- 2.1 Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate 62
- 2.2 Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses 77
- 2.3 Prepare an Income Statement, Statement of Owner's Equity, and Balance Sheet 81

3 Analyzing and Recording Transactions 115

- 3.1 Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements 116
- 3.2 Define and Describe the Expanded Accounting Equation and Its Relationship to Analyzing Transactions 124
- 3.3 Define and Describe the Initial Steps in the Accounting Cycle 130
- 3.4 Analyze Business Transactions Using the Accounting Equation and Show the Impact of Business Transactions on Financial Statements 135
- 3.5 Use Journal Entries to Record Transactions and Post to T-Accounts 140
- 3.6 Prepare a Trial Balance 165

4 The Adjustment Process 211

- 4.1 Explain the Concepts and Guidelines Affecting Adjusting Entries 212
- 4.2 Discuss the Adjustment Process and Illustrate Common Types of Adjusting Entries 215
- 4.3 Record and Post the Common Types of Adjusting Entries 227
- 4.4 Use the Ledger Balances to Prepare an Adjusted Trial Balance 236
- 4.5 Prepare Financial Statements Using the Adjusted Trial Balance 239

5 Completing the Accounting Cycle 285

- 5.1 Describe and Prepare Closing Entries for a Business 286
- 5.2 Prepare a Post-Closing Trial Balance 298

- 5.3 Apply the Results from the Adjusted Trial Balance to Compute Current Ratio and Working Capital Balance, and Explain How These Measures Represent Liquidity 300
- 5.4 Appendix: Complete a Comprehensive Accounting Cycle for a Business 313

6 Merchandising Transactions 365

- 6.1 Compare and Contrast Merchandising versus Service Activities and Transactions 366
- 6.2 Compare and Contrast Perpetual versus Periodic Inventory Systems 378
- 6.3 Analyze and Record Transactions for Merchandise Purchases Using the Perpetual Inventory System 386
- 6.4 Analyze and Record Transactions for the Sale of Merchandise Using the Perpetual Inventory System 392
- 6.5 Discuss and Record Transactions Applying the Two Commonly Used Freight-In Methods 400
- 6.6 Describe and Prepare Multi-Step and Simple Income Statements for Merchandising Companies 404
- 6.7 Appendix: Analyze and Record Transactions for Merchandise Purchases and Sales Using the Periodic Inventory System 408

7 Accounting Information Systems 451

- 7.1 Define and Describe the Components of an Accounting Information System 452
- 7.2 Describe and Explain the Purpose of Special Journals and Their Importance to Stakeholders 466
- 7.3 Analyze and Journalize Transactions Using Special Journals 476
- 7.4 Prepare a Subsidiary Ledger 487
- 7.5 Describe Career Paths Open to Individuals with a Joint Education in Accounting and Information Systems 494

8 Fraud, Internal Controls, and Cash 531

- 8.1 Analyze Fraud in the Accounting Workplace 532
- 8.2 Define and Explain Internal Controls and Their Purpose within an Organization 535
- 8.3 Describe Internal Controls within an Organization 542
- 8.4 Define the Purpose and Use of a Petty Cash Fund, and Prepare Petty Cash Journal Entries 547
- 8.5 Discuss Management Responsibilities for Maintaining Internal Controls within an Organization 551
- 8.6 Define the Purpose of a Bank Reconciliation, and Prepare a Bank Reconciliation and Its Associated Journal Entries 552
- 8.7 Describe Fraud in Financial Statements and Sarbanes-Oxley Act Requirements 555

9 Accounting for Receivables 577

- 9.1 Explain the Revenue Recognition Principle and How It Relates to Current and Future Sales and Purchase Transactions 578
- 9.2 Account for Uncollectible Accounts Using the Balance Sheet and Income Statement Approaches 584

- 9.3 Determine the Efficiency of Receivables Management Using Financial Ratios 594
- 9.4 Discuss the Role of Accounting for Receivables in Earnings Management 599
- 9.5 Apply Revenue Recognition Principles to Long-Term Projects 603
- 9.6 Explain How Notes Receivable and Accounts Receivable Differ 606
- 9.7 Appendix: Comprehensive Example of Bad Debt Estimation 612

10 Inventory 647

- 10.1 Describe and Demonstrate the Basic Inventory Valuation Methods and Their Cost Flow Assumptions 648
- 10.2 Calculate the Cost of Goods Sold and Ending Inventory Using the Periodic Method 657
- 10.3 Calculate the Cost of Goods Sold and Ending Inventory Using the Perpetual Method 663
- 10.4 Explain and Demonstrate the Impact of Inventory Valuation Errors on the Income Statement and Balance Sheet 672
- 10.5 Examine the Efficiency of Inventory Management Using Financial Ratios 674

11 Long-Term Assets 699

- 11.1 Distinguish between Tangible and Intangible Assets 700
- 11.2 Analyze and Classify Capitalized Costs versus Expenses 704
- 11.3 Explain and Apply Depreciation Methods to Allocate Capitalized Costs 709
- 11.4 Describe Accounting for Intangible Assets and Record Related Transactions 721
- 11.5 Describe Some Special Issues in Accounting for Long-Term Assets 723

12 Current Liabilities 745

- 12.1 Identify and Describe Current Liabilities 746
- 12.2 Analyze, Journalize, and Report Current Liabilities 755
- 12.3 Define and Apply Accounting Treatment for Contingent Liabilities 764
- 12.4 Prepare Journal Entries to Record Short-Term Notes Payable 773
- 12.5 Record Transactions Incurred in Preparing Payroll 777

13 Long-Term Liabilities 809

- 13.1 Explain the Pricing of Long-Term Liabilities 810
- 13.2 Compute Amortization of Long-Term Liabilities Using the Effective-Interest Method 822
- 13.3 Prepare Journal Entries to Reflect the Life Cycle of Bonds 830
- 13.4 Appendix: Special Topics Related to Long-Term Liabilities 842

14 Corporation Accounting 859

- 14.1 Explain the Process of Securing Equity Financing through the Issuance of Stock 860
- 14.2 Analyze and Record Transactions for the Issuance and Repurchase of Stock 871
- 14.3 Record Transactions and the Effects on Financial Statements for Cash Dividends, Property Dividends, Stock Dividends, and Stock Splits 879

- 14.4** Compare and Contrast Owners' Equity versus Retained Earnings 890
- 14.5** Discuss the Applicability of Earnings per Share as a Method to Measure Performance 897

15 Partnership Accounting 925

- 15.1** Describe the Advantages and Disadvantages of Organizing as a Partnership 926
- 15.2** Describe How a Partnership Is Created, Including the Associated Journal Entries 932
- 15.3** Compute and Allocate Partners' Share of Income and Loss 935
- 15.4** Prepare Journal Entries to Record the Admission and Withdrawal of a Partner 938
- 15.5** Discuss and Record Entries for the Dissolution of a Partnership 943

16 Statement of Cash Flows 955

- 16.1** Explain the Purpose of the Statement of Cash Flows 956
- 16.2** Differentiate between Operating, Investing, and Financing Activities 957
- 16.3** Prepare the Statement of Cash Flows Using the Indirect Method 959
- 16.4** Prepare the Completed Statement of Cash Flows Using the Indirect Method 971
- 16.5** Use Information from the Statement of Cash Flows to Prepare Ratios to Assess Liquidity and Solvency 974
- 16.6** Appendix: Prepare a Completed Statement of Cash Flows Using the Direct Method 979

A Financial Statement Analysis 1009

B Time Value of Money 1021

C Suggested Resources 1025

Index 1041

Preface

Welcome to *Principles of Accounting*, an OpenStax resource. This textbook was written to increase student access to high-quality learning materials, maintaining highest standards of academic rigor at little to no cost.

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About *Principles of Accounting*

Principles of Accounting is designed to meet the scope and sequence requirements of a two-semester accounting course that covers the fundamentals of financial and managerial accounting. This book is specifically designed to appeal to both accounting and non-accounting majors, exposing students to the core concepts of accounting in familiar ways to build a strong foundation that can be applied across business fields. Each chapter opens with a relatable real-life scenario for today's college student. Thoughtfully designed examples are presented throughout each chapter, allowing students to build on emerging accounting knowledge. Concepts are further reinforced through applicable connections to more detailed business processes. Students are immersed in the "why" as well as the "how" aspects of accounting in order to reinforce concepts and promote comprehension over rote memorization.

Coverage and scope

Our *Principles of Accounting* textbook adheres to the scope and sequence requirements of accounting courses nationwide. We have endeavored to make the core concepts and practical applications of accounting engaging, relevant, and accessible to students.

Principles of Accounting, Volume 1: Financial Accounting

Chapter 1: The Role of Accounting in Society

Chapter 2: Introduction to Financial Statements

Chapter 3: Analyzing and Recording Transactions

Chapter 4: The Adjustment Process

Chapter 5: Completing the Accounting Cycle

Chapter 6: Merchandising Transactions

Chapter 7: Accounting Information Systems

Chapter 8: Fraud, Internal Controls, and Cash

Chapter 9: Accounting for Receivables

Chapter 10: Inventory

Chapter 11: Long-Term Assets

Chapter 12: Current Liabilities

Chapter 13: Long-Term Liabilities

Chapter 14: Corporation Accounting

Chapter 15: Partnership Accounting

Chapter 16: Statement of Cash Flows

Principles of Accounting, Volume 2: Managerial Accounting

Chapter 1: Accounting as a Tool for Managers

Chapter 2: Building Blocks of Managerial Accounting

Chapter 3: Cost-Volume-Profit Analysis

Chapter 4: Job Order Costing

Chapter 5: Process Costing

Chapter 6: Activity-Based, Variable, and Absorption Costing

Chapter 7: Budgeting

Chapter 8: Standard Costs and Variances

Chapter 9: Responsibility Accounting and Decentralization

Chapter 10: Short-Term Decision-Making

Chapter 11: Capital Budgeting Decisions

Chapter 12: Balanced Scorecard and Other Performance Measures

Chapter 13: Sustainability Reporting

Engaging feature boxes

Throughout *Principles of Accounting*, you will find features that engage students by taking selected topics a step further.

- **Your Turn.** This feature provides students an opportunity to apply covered concepts.
- **Concepts in Practice.** This feature takes students beyond mechanics and illustrates the utility of a given concept for accountants and non-accountants. We encourage instructors to reference these as part of their in-class lectures and assessments to provide easily relatable applications.
- **Think It Through.** This scenario-based feature puts students in the role of decision-maker. With topics ranging from ethical dilemmas to conflicting analytical results, the purpose of this feature is to teach students that in the real world not every question has just one answer.
- **Continuing Application at Work.** This feature follows an individual company or segment of an industry and examines how businesspeople conduct the decision-making process in different situations. It allows students to see how concepts build on each other.
- **Ethical Considerations.** This feature illustrates the ethical implication of decisions, how accounting concepts are applied to real-life examples, and how financial and managerial decisions can impact many stakeholders.
- **IFRS Connection.** This feature presents the differences and similarities between U.S. GAAP and IFRS, helping students understand how accounting concepts and rules between countries may vary and thus affect financial reporting and decision-making.
- **Link to Learning.** This feature provides a very brief introduction to online resources and videos that are pertinent to students' exploration of the topic at hand.

Pedagogical features that reinforce key concepts

- **Learning Objectives.** Each chapter is organized into sections based on clear and comprehensive learning objectives that help guide students on what they can expect to learn. After completing the modules and assessments, students should be able to demonstrate mastery of the learning objectives.
- **Summaries.** Designed to support both students and instructors, section summaries distill the information in each module down to key, concise points.
- **Key Terms.** Key terms are bolded the first time that they are used and are followed by a definition in context. Definitions of key terms are also listed in the glossary, which appears at the end of the chapter.

Assessments to test comprehension and practice skills

An assortment of assessment types are provided in this text to allow for practice and self-assessment throughout the course of study.

- **Multiple Choice.** are basic review questions that test comprehension.
- **Questions** include brief, open-response questions to test comprehension.
- **Exercises** (Sets A and B) are application Application questions that require a combination of quantitative and analytical skills.
- **Problems** (Sets A and B) are advanced Advanced activities that allow students to demonstrate learning and application of multiple learning objectives and skills concurrently in one set of facts. Problems are designed to assess higher levels of Bloom's taxonomy.
- **Thought Provokers** are open-ended questions, often with more than one acceptable response, designed to stretch students intellectually.

Effective art program

Our art program is designed to enhance students' understanding of concepts through clear and effective presentations of financial materials and diagrams.

JOURNAL			
Date	Account	Debit	Credit
	Cost of Goods Sold Finished Goods Inventory <i>To record the cost of products sold</i>	25,000	25,000

Figure 1 Journal Entry.

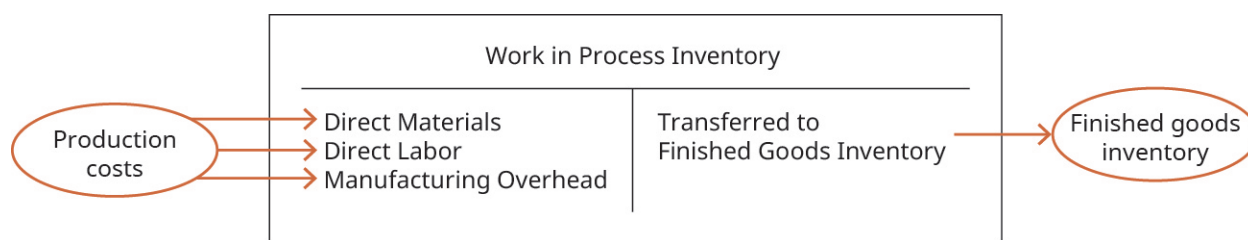


Figure 2 Work in Process Inventory T-Account.

WHICHARD & KLEIN, LLP	
Income Statement	
For the Year Ended December 31, 2019	
Service Revenue	\$412,000
Operating Expenses	
Salaries	210,000
Office Expense	35,000
Office Equipment	9,000
Administrative Salaries	45,000
Utilities	11,000
Miscellaneous	7,500
Total Operating Expenses	<u>317,500</u>
Operating Income	<u>\$ 94,500</u>

Figure 3 Income Statement.

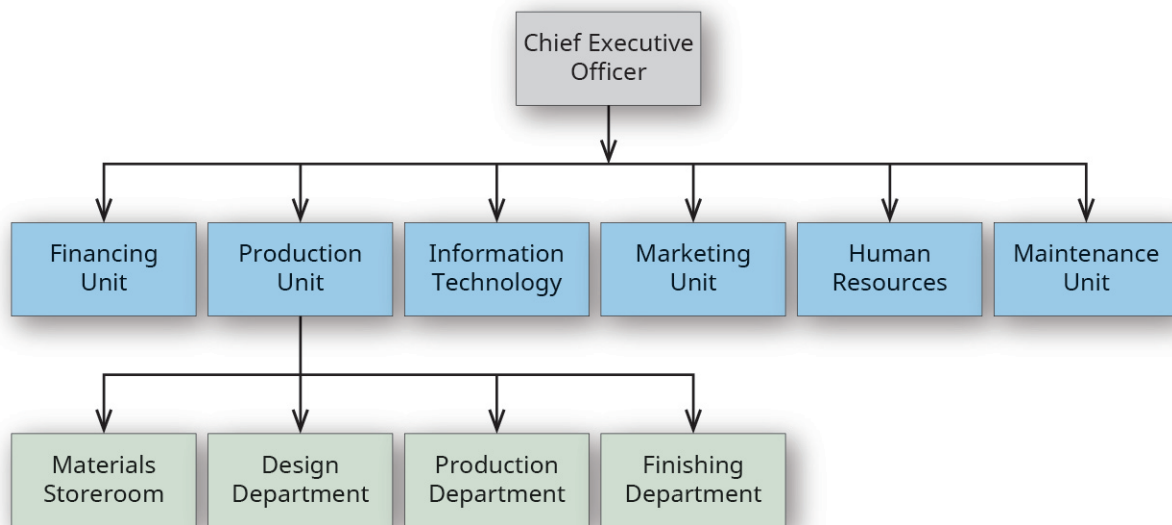


Figure 4 Organizational Chart.

Year	Cash Interest Payment	Interest on Carrying Value	Amortization of Discount	Carrying Value
Jan. 1 Year 1				91,800
Dec. 31 Year 1	5,000	6,426	1,426	93,226
Dec. 31 Year 2	5,000	6,526	1,526	94,752
Dec. 31 Year 3	5,000	6,633	1,633	96,384
Dec. 31 Year 4	5,000	6,747	1,747	98,131
Dec. 31 Year 5	5,000	6,869	1,869	100,000

Figure 5 Cash Interest Payment.

GENERAL LEDGER					
Cash					Account No. 101
Date	Item	Ref.	Debit	Credit	Balance
2019					
Jan. 3	Cash for common stock		20,000		20,000
Jan. 9	Payment from client		4,000		24,000
Jan. 12	Utility bill			300	23,700
Jan. 14	Dividends payment			100	23,600
Jan. 17	Cash for services		2,800		26,400
Jan. 18	Paid cash for equipment			3,500	22,900
Jan. 20	Paid employee salaries			3,600	19,300
Jan. 23	Customer payment		5,500		24,800

Figure 6 General Ledger.

Additional resources

Student and instructor resources

We've compiled additional resources for both students and instructors, including Getting Started Guides, an instructor solution guide, and companion presentation slides. Instructor resources require a verified instructor account, which you can apply for when you log in or create your account on openstax.org. Instructor and student resources are typically available within a few months after the book's initial publication. Take advantage of these resources to supplement your OpenStax book.

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1

Role of Accounting in Society

Figure 1.1 Careers and Accounting. Promotional opportunities throughout a person's career may involve managerial responsibilities and often include responsibility for a portion of the organization's financial performance. Having an understanding of how accounting affects businesses can help the individual to be successful in meeting the organization's strategic and financial goals. (credit: modification of "Achievement" by unknown/Pixabay, CC0)

Chapter Outline

- L0 1.1** Explain the Importance of Accounting and Distinguish between Financial and Managerial Accounting
- L0 1.2** Identify Users of Accounting Information and How They Apply Information
- L0 1.3** Describe Typical Accounting Activities and the Role Accountants Play in Identifying, Recording, and Reporting Financial Activities
- L0 1.4** Explain Why Accounting Is Important to Business Stakeholders
- L0 1.5** Describe the Varied Career Paths Open to Individuals with an Accounting Education



Why It Matters

Jennifer has been in the social work profession for over 25 years. After graduating college, she started working at an agency that provided services to homeless women and children. Part of her role was to work directly with the homeless women and children to help them acquire adequate shelter and other necessities. Jennifer currently serves as the director of an organization that provides mentoring services to local youth.

Looking back on her career in the social work field, Jennifer indicates that there are two things that surprised her. The first thing that surprised her was that as a trained social worker she would ultimately become a director of a social work agency and would be required to make financial decisions about programs and how the money is spent. As a college student, she thought social workers would spend their entire careers providing direct support to their clients. The second thing that surprised her was how valuable it is for

directors to have an understanding of accounting. She notes, “The best advice I received in college was when my advisor suggested I take an accounting course. As a social work student, I was reluctant to do so because I did not see the relevance. I didn’t realize so much of an administrator’s role involves dealing with financial issues. I’m thankful that I took the advice and studied accounting. For example, I was surprised that I would be expected to routinely present to the board our agency’s financial performance. The board includes several business professionals and leaders from other agencies. Knowing the accounting terms and having a good understanding of the information contained in the financial reports gives me a lot of confidence when answering their questions. In addition, understanding what influences the financial performance of our agency better prepares me to plan for the future.”

1.1 Explain the Importance of Accounting and Distinguish between Financial and Managerial Accounting

Accounting is the process of organizing, analyzing, and communicating financial information that is used for decision-making. Financial information is typically prepared by accountants—those trained in the specific techniques and practices of the profession. This course explores many of the topics and techniques related to the accounting profession. While many students will directly apply the knowledge gained in this course to continue their education and become accountants and business professionals, others might pursue different career paths. However, a solid understanding of accounting can for many still serve as a useful resource. In fact, it is hard to think of a profession where a foundation in the principles of accounting would not be beneficial. Therefore, one of the goals of this course is to provide a solid understanding of how financial information is prepared and used in the workplace, regardless of your particular career path.

THINK IT THROUGH

Expertise

Every job or career requires a certain level of technical expertise and an understanding of the key aspects necessary to be successful. The time required to develop the expertise for a particular job or career varies from several months to much longer. For instance, doctors, in addition to the many years invested in the classroom, invest a significant amount of time providing care to patients under the supervision of more experienced doctors. This helps medical professionals develop the necessary skills to quickly and effectively diagnose and treat the various medical conditions they spent so many years learning about.



Figure 1.2 College Graduation. (credit: modification of “140501-A-XA877-046” by Fort Wainwright Public Affairs Office/Flickr, CC BY 2.0)

Accounting also typically takes specialized training. Top accounting managers often invest many years and have a significant amount of experience mastering complex financial transactions. Also, in addition to attending college, earning professional certifications and investing in continuing education are necessary to develop a skill set sufficient to becoming experts in an accounting professional field.

The level and type of training in accounting are often dependent on which of the myriad options of accounting fields the potential accountant chooses to enter. To familiarize you with some potential opportunities, [Describe the Varied Career Paths Open to Individuals with an Accounting Education](#) examines many of these career options. In addition to covering an assortment of possible career opportunities, we address some of the educational and experiential certifications that are available. Why do you think accountants (and doctors) need to be certified and secure continuing education? In your response, defend your position with examples.

In addition to doctors and accountants, what other professions can you think of that might require a significant investment of time and effort in order to develop an expertise?

A traditional adage states that “accounting is the language of business.” While that is true, you can also say that “accounting is the language of life.” At some point, most people will make a decision that relies on accounting information. For example, you may have to decide whether it is better to lease or buy a vehicle. Likewise, a college graduate may have to decide whether it is better to take a higher-paying job in a bigger city (where the cost of living is also higher) or a job in a smaller community where both the pay and cost of living may be lower.

In a professional setting, a theater manager may want to know if the most recent play was profitable. Similarly, the owner of the local plumbing business may want to know whether it is worthwhile to pay an employee to be “on call” for emergencies during off-hours and weekends. Whether personal or professional, accounting information plays a vital role in all of these decisions.

You may have noticed that the decisions in these scenarios would be based on factors that include both financial and nonfinancial information. For instance, when deciding whether to lease or buy a vehicle, you would consider not only the monthly payments but also such factors as vehicle maintenance and reliability. The college graduate considering two job offers might weigh factors such as working hours, ease of commuting, and options for shopping and entertainment. The theater manager would analyze the proceeds from ticket sales and sponsorships as well as the expenses for production of the play and operating the concessions. In addition, the theater manager should consider how the financial performance of the play might have been influenced by the marketing of the play, the weather during the performances, and other factors such as competing events during the time of the play. All of these factors, both financial and nonfinancial, are relevant to the financial performance of the play. In addition to the additional cost of having an employee “on call” during evenings and weekends, the owner of the local plumbing business would consider nonfinancial factors in the decision. For instance, if there are no other plumbing businesses that offer services during evenings and weekends, offering emergency service might give the business a strategic advantage that could increase overall sales by attracting new customers.

This course explores the role that accounting plays in society. You will learn about **financial accounting**, which measures the financial performance of an organization using standard conventions to prepare and distribute financial reports. Financial accounting is used to generate information for stakeholders *outside* of an organization, such as owners, stockholders, lenders, and governmental entities such as the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS).

Financial accounting is also a foundation for understanding **managerial accounting**, which uses both financial and nonfinancial information as a basis for making decisions within an organization with the purpose of equipping decision makers to set and evaluate business goals by determining what information they need to make a particular decision and how to analyze and communicate this information. Managerial accounting information tends to be used internally, for such purposes as budgeting, pricing, and determining production costs. Since the information is generally used internally, you do not see the same need for financial oversight in an organization's managerial data.

You will also note in your financial accounting studies that there are governmental and organizational entities that oversee the accounting processes and systems that are used in financial accounting. These entities include organizations such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Public Company Accounting Oversight Board (PCAOB). The PCAOB was created after several major cases of corporate fraud, leading to the Sarbanes-Oxley Act of 2002, known as SOX. If you choose to pursue more advanced accounting courses, especially auditing courses, you will address the SOX in much greater detail.

For now, it is not necessary to go into greater detail about the mechanics of these organizations or other accounting and financial legislation. You just need to have a basic understanding that they function to provide a degree of protection for those outside of the organization who rely on the financial information.

Whether or not you aspire to become an accountant, understanding financial and managerial accounting is valuable and necessary for practically any career you will pursue. Management of a car manufacturer, for example, would use both financial and managerial accounting information to help improve the business. Financial accounting information is valuable as it measures whether or not the company was financially successful. Knowing this provides management with an opportunity to repeat activities that have proven effective and to make adjustments in areas in which the company has underperformed. Managerial accounting information is likewise valuable. Managers of the car manufacturer may want to know, for example, how much scrap is generated from a particular area in the manufacturing process. While identifying and improving the manufacturing process (i.e., reducing scrap) helps the company financially, it may also help other areas of the production process that are indirectly related, such as poor quality and shipping delays.

1.2 Identify Users of Accounting Information and How They Apply Information

The ultimate goal of accounting is to provide information that is useful for decision-making. Users of accounting information are generally divided into two categories: internal and external. Internal users are those within an organization who use financial information to make day-to-day decisions. Internal users include managers and other employees who use financial information to confirm past results and help make adjustments for future activities.

External users are those outside of the organization who use the financial information to make decisions or to evaluate an entity's performance. For example, investors, financial analysts, loan officers, governmental auditors, such as IRS agents, and an assortment of other stakeholders are classified as external users, while still having an interest in an organization's financial information. (Stakeholders are addressed in greater detail in [Explain Why Accounting Is Important to Business Stakeholders](#).)

Characteristics, Users, and Sources of Financial Accounting Information

Organizations measure financial performance in monetary terms. In the United States, the dollar is used as the standard measurement basis. Measuring financial performance in monetary terms allows managers to compare the organization's performance to previous periods, to expectations, and to other organizations or industry standards.

Financial accounting is one of the broad categories in the study of accounting. While some industries and types of organizations have variations in how the financial information is prepared and communicated, accountants generally use the same methodologies—called accounting standards—to prepare the financial information. You learn in [Introduction to Financial Statements](#) that financial information is primarily communicated through financial statements, which include the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows and Disclosures. These financial statements ensure the information is consistent from period to period and generally comparable between organizations. The conventions also ensure that the information provided is both reliable and relevant to the user.

Virtually every activity and event that occurs in a business has an associated cost or value and is known as a **transaction**. Part of an accountant's responsibility is to quantify these activities and events. In this course you will learn about the many types of transactions that occur within a business. You will also examine the effects of these transactions, including their impact on the financial position of the entity.

Accountants often use computerized accounting systems to record and summarize the financial reports, which offer many benefits. The primary benefit of a computerized accounting system is the efficiency by which transactions can be recorded and summarized, and financial reports prepared. In addition, computerized accounting systems store data, which allows organizations to easily extract historical financial information.

Common computerized accounting systems include QuickBooks, which is designed for small organizations, and SAP, which is designed for large and/or multinational organizations. QuickBooks is popular with smaller, less complex entities. It is less expensive than more sophisticated software packages, such as Oracle or SAP, and the QuickBooks skills that accountants developed at previous employers tend to be applicable to the needs of new employers, which can reduce both training time and costs spent on acclimating new employees to an employer's software system. Also, being familiar with a common software package such as QuickBooks helps provide employment mobility when workers wish to reenter the job market.

While QuickBooks has many advantages, once a company's operations reach a certain level of complexity, it will need a basic software package or platform, such as Oracle or SAP, which is then customized to meet the unique informational needs of the entity.

Financial accounting information is mostly historical in nature, although companies and other entities also incorporate estimates into their accounting processes. For example, you will learn how to use estimates to determine bad debt expenses or depreciation expenses for assets that will be used over a multiyear lifetime. That is, accountants prepare financial reports that summarize what has already occurred in an organization. This information provides what is called feedback value. The benefit of reporting what has already occurred is the reliability of the information. Accountants can, with a fair amount of confidence, accurately report the financial performance of the organization related to past activities. The feedback value offered by the accounting information is particularly useful to internal users. That is, reviewing how the organization performed in the past can help managers and other employees make better decisions about and adjustments to future activities.

Financial information has limitations, however, as a predictive tool. Business involves a large amount of

uncertainty, and accountants cannot predict how the organization will perform in the future. However, by observing historical financial information, users of the information can detect patterns or trends that may be useful for estimating the company's future financial performance. Collecting and analyzing a series of historical financial data is useful to both internal and external users. For example, internal users can use financial information as a predictive tool to assess whether the long-term financial performance of the organization aligns with its long-term strategic goals.

External users also use the historical pattern of an organization's financial performance as a predictive tool. For example, when deciding whether to loan money to an organization, a bank may require a certain number of years of financial statements and other financial information from the organization. The bank will assess the historical performance in order to make an informed decision about the organization's ability to repay the loan and interest (the cost of borrowing money). Similarly, a potential investor may look at a business's past financial performance in order to assess whether or not to invest money in the company. In this scenario, the investor wants to know if the organization will provide a sufficient and consistent return on the investment. In these scenarios, the financial information provides value to the process of allocating scarce resources (money). If potential lenders and investors determine the organization is a worthwhile investment, money will be provided, and, if all goes well, those funds will be used by the organization to generate additional value at a rate greater than the alternate uses of the money.

Characteristics, Users, and Sources of Managerial Accounting Information

As you've learned, managerial accounting information is different from financial accounting information in several respects. Accountants use formal accounting standards in financial accounting. These accounting standards are referred to as **generally accepted accounting principles (GAAP)** and are the common set of rules, standards, and procedures that publicly traded companies must follow when composing their financial statements. The previously mentioned **Financial Accounting Standards Board (FASB)**, an independent, nonprofit organization that sets financial accounting and reporting standards for both public and private sector businesses in the United States, uses the GAAP guidelines as its foundation for its system of accepted accounting methods and practices, reports, and other documents.

Since most managerial accounting activities are conducted for internal uses and applications, managerial accounting is not prepared using a comprehensive, prescribed set of conventions similar to those required by financial accounting. This is because managerial accountants provide managerial accounting information that is intended to serve the needs of internal, rather than external, users. In fact, managerial accounting information is rarely shared with those outside of the organization. Since the information often includes strategic or competitive decisions, managerial accounting information is often closely protected. The business environment is constantly changing, and managers and decision makers within organizations need a variety of information in order to view or assess issues from multiple perspectives.

Accountants must be adaptable and flexible in their ability to generate the necessary information management decision-making. For example, information derived from a computerized accounting system is often the starting point for obtaining managerial accounting information. But accountants must also be able to extract information from other sources (internal and external) and analyze the data using mathematical, formula-driven software (such as Microsoft Excel).

Management accounting information as a term encompasses many activities within an organization. Preparing a budget, for example, allows an organization to estimate the financial performance for the

upcoming year or years and plan for adjustments to scale operations according to the projections.

Accountants often lead the budgeting process by gathering information from internal (estimates from the sales and engineering departments, for example) and external (trade groups and economic forecasts, for example) sources. These data are then compiled and presented to decision makers within the organization.

Examples of other decisions that require management accounting information include whether an organization should repair or replace equipment, make products internally or purchase the items from outside vendors, and hire additional workers or use automation.

As you have learned, management accounting information uses both financial and nonfinancial information. This is important because there are situations in which a purely financial analysis might lead to one decision, while considering nonfinancial information might lead to a different decision. For example, suppose a financial analysis indicates that a particular product is unprofitable and should no longer be offered by a company. If the company fails to consider that customers also purchase a complementary good (you might recall that term from your study of economics), the company may be making the wrong decision. For example, assume that you have a company that produces and sells both computer printers and the replacement ink cartridges. If the company decided to eliminate the printers, then it would also lose the cartridge sales. In the past, in some cases, the elimination of one component, such as printers, led to customers switching to a different producer for its computers and other peripheral hardware. In the end, an organization needs to consider both the financial and nonfinancial aspects of a decision, and sometimes the effects are not intuitively obvious at the time of the decision. [Figure 1.3](#) offers an overview of some of the differences between financial and managerial accounting.

COMMUNICATION THROUGH REPORTING	FINANCIAL ACCOUNTING	MANAGERIAL ACCOUNTING
Users of reports	External users: stockholders, creditors, regulators	Internal users: managers, officers, and other employees
Types of reports	Financial statements: balance sheet, income statement, cash-flow statement, etc.	Internal reports: job cost sheet, cost of goods manufactured, production cost report, etc.
Frequency of reports	Quarterly; annually	As frequently as needed
Purpose of reports	Helps those external users make decisions: credit terms, investment, and other decisions	Assists the internal users in the planning and control decision-making process
Focus of reports	Pertains to company as a whole Uses GAAP structure Composed from a multitude or combination of other more individual data	Pertains to departments, sections of the business Very detailed reporting No GAAP constraints
Nature of reports	Monetary	Monetary and nonmonetary information
Verification of reports	Audited by CPA	No independent audits

Figure 1.3 Comparing Reports between Financial and Managerial Accounting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

1.3 Describe Typical Accounting Activities and the Role Accountants Play in Identifying, Recording, and Reporting Financial Activities

We can classify organizations into three categories: for profit, governmental, and not for profit. These organizations are similar in several aspects. For example, each of these organizations has inflows and outflows of cash and other resources, such as equipment, furniture, and land, that must be managed. In addition, all of these organizations are formed for a specific purpose or mission and want to use the available resources in an efficient manner—the organizations strive to be good stewards, with the underlying premise of being profitable. Finally, each of the organizations makes a unique and valuable contribution to society. Given the similarities, it is clear that all of these organizations have a need for accounting information and for accountants to provide that information.

There are also several differences. The main difference that distinguishes these organizations is the primary purpose or mission of the organization, discussed in the following sections.

For-Profit Businesses

As the name implies, the primary purpose or mission of a **for-profit business** is to earn a profit by selling

goods and services. There are many reasons why a for-profit business seeks to earn a profit. The profits generated by these organizations might be used to create value for employees in the form of pay raises for existing employees as well as hiring additional workers. In addition, profits can be reinvested in the business to create value in the form of research and development, equipment upgrades, facilities expansions, and many other activities that make the business more competitive. Many companies also engage in charitable activities, such as donating money, donating products, or allowing employees to volunteer in the communities. Finally, profits can also be shared with employees in the form of either bonuses or commissions as well as with owners of the business as a reward for the owners' investment in the business. These issues, along with others, and the associated accounting conventions will be explored throughout this course.

In for-profit businesses, accounting information is used to measure the financial performance of the organization and to help ensure that resources are being used efficiently. Efficiently using existing resources allows the businesses to improve quality of the products and services offered, remain competitive in the marketplace, expand when appropriate, and ensure longevity of the business.

For-profit businesses can be further categorized by the types of products or services the business provides. Let's examine three types of for-profit businesses: manufacturing, retail (or merchandising), and service.

Manufacturing Businesses

A **manufacturing business** is a for-profit business that is designed to make a specific product or products. Manufacturers specialize in procuring components in the most basic form (often called direct or raw materials) and transforming the components into a finished product that is often drastically different from the original components.

As you think about the products you use every day, you are probably already familiar with products made by manufacturing firms. Examples of products made by manufacturing firms include automobiles, clothes, cell phones, computers, and many other products that are used every day by millions of consumers.

In [Job Order Costing \(http://cnx.org/content/m68122/latest/\)](http://cnx.org/content/m68122/latest/), you will examine the process of job costing, learning how manufacturing firms transform basic components into finished, sellable products and the techniques accountants use to record the costs associated with these activities.

CONCEPTS IN PRACTICE

Manufacturing

Think about the items you have used today. Make a list of the products that were created by manufacturing firms. How many can you think of? Think of the many components that went into some of the items you use. Do you think the items were made by machines or by hand?

If you are in a classroom with other students, see who has used the greatest number of items today. Or, see who used the item that would be the most complex to manufacture.

If you are able, you might consider arranging a tour of a local manufacturer. Many manufacturers are happy to give tours of the facilities and describe the many complex processes that are involved in making the products. On your tour, take note of the many job functions that are required to make those

items—from ordering the materials to delivering to the customer.

Retail Businesses

Manufacturing businesses and retail (or merchandising) businesses are similar in that both are for-profit businesses that sell products to consumers. In the case of manufacturing firms, by adding direct labor, manufacturing overhead (such as utilities, rent, and depreciation), and other direct materials, raw components are converted into a finished product that is sold to consumers. A **retail business** (or merchandising business), on the other hand, is a for-profit business that purchases products (called inventory) and then resells the products without altering them—that is, the products are sold directly to the consumer in the same condition (production state) as purchased.

Examples of retail firms are plentiful. Automobile dealerships, clothes, cell phones, and computers are all examples of everyday products that are purchased and sold by retail firms. What distinguishes a manufacturing firm from a retail firm is that in a retail firm, the products are sold in the same condition as when the products were purchased—no further alterations were made on the products.

Did you happen to notice that the product examples listed in the preceding paragraph (automobiles, clothes, cell phones, and computers) for manufacturing firms and retail firms are identical? If so, congratulations, because you are paying close attention to the details. These products are used as examples in two different contexts—that is, manufacturing firms *make* these products, and retail firms *sell* these products. These products are relevant to both manufacturing and retail because they are examples of goods that are both manufactured and sold directly to the consumer. While there are instances when a manufacturing firm also serves as the retail firm (**Dell** computers, for example), it is often the case that products will be manufactured and sold by separate firms.

CONCEPTS IN PRACTICE

NIKEiD

NIKEiD is a program that allows consumers to design and purchase customized equipment, clothes, and shoes. In 2007, **Nike** opened its first NIKEiD studio at Niketown in New York City.^[1] Since its debut in 1999, the NIKEiD concept has flourished, and **Nike** has partnered with professional athletes to showcase their designs that, along with featured consumer designs, are available for purchase on the NIKEiD website.

1 Nike. "Nike Opens New NIKEiD Studio in New York." October 4, 2007. <https://news.nike.com/news/nike-opens-new-nikeid-studio-in-new-york>



Figure 1.4 NIKEiD Launch Store in Shanghai. (credit: "Nike-id-shanghai-launch" by "All.watson"/Wikimedia Commons, CC BY 2.0)

Assume you are the manager of a sporting goods store that sells Nike shoes. Think about the concept of NIKEiD, and consider the impact that this concept might have on your store sales. Would this positively or negatively impact the sale of Nike shoes in your store? What are steps you could take to leverage the NIKEiD concept to help increase your own store's sales?

Considerations like this are examples of what marketing professionals would address. Nike wants to ensure this concept does not negatively impact the existing relationships it has, and Nike works to ensure this program is also beneficial to its existing distribution partners.

In [Merchandising Transactions](#) you will learn about merchandising transactions, which include concepts and specific accounting practices for retail firms. You will learn, among other things, how to account for purchasing products from suppliers, selling the products to customers, and prepare the financial reports for retail firms.

Service Businesses

As the term implies, service businesses are businesses that provide services to customers. A major difference between manufacturing and retail firms and service firms is that service firms do not have a tangible product that is sold to customers. Instead, a **service business** does not sell tangible products to customers but rather provides intangible benefits (services) to customers. A service business can be either a for-profit or a not-for-profit business. [Figure 1.5](#) illustrates the distinction between manufacturing, retail, and service businesses.

Examples of service-oriented businesses include hotels, cab services, entertainment, and tax preparers. Efficiency is one advantage service businesses offer to their customers. For example, while taxpayers can certainly read the tax code, read the instructions, and complete the forms necessary to file their annual tax returns, many choose to take their tax returns to a person who has specialized training and experience with

preparing tax returns. Although it is more expensive to do so, many feel it is a worthwhile investment because the tax professional has invested the time and has the knowledge to prepare the forms properly and in a timely manner. Hiring a tax preparer is efficient for the taxpayer because it allows the taxpayer to file the required forms without having to invest numerous hours researching and preparing the forms.

The accounting conventions for service businesses are similar to the accounting conventions for manufacturing and retail businesses. In fact, the accounting for service businesses is easier in one respect. Because service businesses do not sell tangible products, there is no need to account for products that are being held for sale (inventory). Therefore, while we briefly discuss service businesses, we'll focus mostly on accounting for manufacturing and retail businesses.



Figure 1.5 Manufacturing, Retail, and Service. An auto manufacturing plant, a car sales lot, and a taxi represent three types of businesses: manufacturing, retail, and service. (credit left: modification of “Maquiladora” by “Guldhammer”/Wikimedia Commons, CC0; credit center: modification of “Mercedes Benz Parked” by unknown/Pixabay, CC0; credit right: modification of “Taxi Overtaking Bus” by “Kai Pilger”/Pixabay, CC0)

YOUR TURN

Categorizing Restaurants

So far, you’ve learned about three types of for-profit businesses: manufacturing, retail, and service. Previously, you saw how some firms such as **Dell** serve as both manufacturer and retailer.

Now, think of the last restaurant where you ate. Of the three business types (manufacturer, retailer, or service provider), how would you categorize the restaurant? Is it a manufacturer? A retailer? A service provider? Can you think of examples of how a restaurant has characteristics of all three types of businesses?

Solution

Answers will vary. Responses may initially consider a restaurant to be only a service provider. Students may also recognize that a restaurant possesses aspects of a manufacturer (by preparing the meals), retailer (by selling merchandise and/or gift cards), and service provider (by waiting on customers).

Governmental Entities

A **governmental entity** provides services to the general public (taxpayers). Governmental agencies exist at the federal, state, and local levels. These entities are funded through the issuance of taxes and other fees.

Accountants working in governmental entities perform the same function as accountants working at for-profit businesses. Accountants help to serve the public interest by providing to the public an accounting for the receipts and disbursements of taxpayer dollars. Governmental leaders are accountable to taxpayers, and accountants help assure the public that tax dollars are being utilized in an efficient manner.

Examples of governmental entities that require financial reporting include federal agencies such as the Social Security Administration, state agencies such as the Department of Transportation, and local agencies such as county engineers.

Students continuing their study of accounting may take a specific course or courses related to governmental accounting. While the specific accounting used in governmental entities differs from traditional accounting conventions, the goal of providing accurate and unbiased financial information useful for decision-making remains the same, regardless of the type of entity. Government accounting standards are governed by the **Governmental Accounting Standards Board (GASB)**. This organization creates standards that are specifically appropriate for state and local governments in the United States.

Not-for-Profit Entities

To be fair, the name “not-for-profit” can be somewhat confusing. As with “for-profit” entities, the name refers to the primary purpose or mission of the organization. In the case of for-profit organizations, the primary purpose is to generate a profit. The profits, then, can be used to sustain and improve the business through investments in employees, research, and development, and other measures intended to help ensure the long-term success of the business.

But in the case of a **nonprofit (not-for-profit) organization** the primary purpose or mission is to serve a particular interest or need in the community. A not-for-profit entity tends to depend on financial longevity based on donations, grants, and revenues generated. It may be helpful to think of not-for-profit entities as “mission-based” entities. It is important to note that not-for-profit entities, while having a primary purpose of serving a particular interest, also have a need for financial sustainability. An adage in the not-for-profit sector states that “being a not-for-profit organization does not mean it is for-loss.” That is, not-for-profit entities must also ensure that resources are used efficiently, allowing for inflows of resources to be greater than (or, at a minimum, equal to) outflows of resources. This allows the organization to continue and perhaps expand its valuable mission.

Examples of not-for-profit entities are numerous. Food banks have as a primary purpose the collection, storage, and distribution of food to those in need. Charitable foundations have as a primary purpose the provision of funding to local agencies that support specific community needs, such as reading and after-school programs. Many colleges and universities are structured as not-for-profit entities because the primary purpose is to provide education and research opportunities.

Similar to accounting for governmental entities, students continuing their study of accounting may take a specific course or courses related to not-for-profit accounting. While the specific accounting used in not-for-profit entities differs slightly from traditional accounting conventions, the goal of providing reliable and unbiased financial information useful for decision-making is vitally important. Some of the governmental and regulatory entities involved in maintaining the rules and principles in accounting are discussed in [Explain Why](#)

Accounting Is Important to Business Stakeholders.

YOUR TURN

Types of Organizations

Think of the various organizations discussed so far. Now try to identify people in your personal and professional network who work for these types of agencies. Can you think of someone in a career at each of these types of organizations?

One way to explore career paths is to talk with professionals who work in the areas that interest you. You may consider reaching out to the individuals you identified and learning more about the work that they do. Find out about the positive and negative aspects of the work. Find out what advice they have relating to education. Try to gain as much information as you can to determine whether that is a career you can envision yourself pursuing. Also, ask about opportunities for job shadowing, co-ops, or internships

Solution

Answers will vary, but this should be an opportunity to learn about careers in a variety of organizations (for-profit including manufacturing, retail, and services; not-for-profit; and governmental agencies). You may have an assumption about a career that is based only on the positive aspects. Learning from experienced professionals may help you understand all aspects of the careers. In addition, this exercise may help you confirm or alter your potential career path, including the preparation required (based on advice given from those you talk with).

1.4

Explain Why Accounting Is Important to Business Stakeholders

The number of decisions we make in a single day is staggering. For example, think about what you had for breakfast this morning. What pieces of information factored into that decision? A short list might include the foods that were available in your home, the amount of time you had to prepare and eat the food, and what sounded good to eat this morning. Let's say you do not have much food in your home right now because you are overdue on a trip to the grocery store. Deciding to grab something at a local restaurant involves an entirely new set of choices. Can you think of some of the factors that might influence the decision to grab a meal at a local restaurant?

YOUR TURN

Daily Decisions

Many academic studies have been conducted on the topic of consumer behavior and decision-making. It is a fascinating topic of study that attempts to learn what type of advertising works best, the best place to locate a business, and many other business-related activities.

One such study, conducted by researchers at Cornell University, concluded that people make more than 200 food-related decisions per day.^[2]

This is astonishing considering the number of decisions found in this particular study related only to decisions involving food. Imagine how many day-to-day decisions involve other issues that are important to us, such as what to wear and how to get from point A to point B. For this exercise, provide and discuss some of the food-related decisions that you recently made.

Solution

In consideration of food-related decisions, there are many options you can consider. For example, what types, in terms of ethnic groups or styles, do you prefer? Do you want a dining experience or just something inexpensive and quick? Do you have allergy-related food issues? These are just a few of the myriad potential decisions you might make.

It is no different when it comes to financial decisions. Decision makers rely on unbiased, relevant, and timely financial information in order to make sound decisions. In this context, the term **stakeholder** refers to a person or group who relies on financial information to make decisions, since they often have an interest in the economic viability of an organization or business. Stakeholders may be stockholders, creditors, governmental and regulatory agencies, customers, management and other employees, and various other parties and entities.

Stockholders

A **stockholder** is an owner of stock in a business. Owners are called stockholders because in exchange for cash, they are given an ownership interest in the business, called stock. Stock is sometimes referred to as “shares.” Historically, stockholders received paper certificates reflecting the number of stocks owned in the business. Now, many stock transactions are recorded electronically. [Introduction to Financial Statements](#) discusses stock in more detail. [Corporation Accounting](#) offers a more extensive exploration of the types of stock as well as the accounting related to stock transactions.

Recall that organizations can be classified as for-profit, governmental, or not-for-profit entities. Stockholders are associated with for-profit businesses. While governmental and not-for-profit entities have constituents, there is no direct ownership associated with these entities.

For-profit businesses are organized into three categories: manufacturing, retail (or merchandising), and service. Another way to categorize for-profit businesses is based on the availability of the company stock (see [Table 1.1](#)). A **publicly traded company** is one whose stock is traded (bought and sold) on an organized stock exchange such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotation (NASDAQ) system. Most large, recognizable companies are publicly traded, meaning the stock is available for sale on these exchanges. A **privately held company**, in contrast, is one whose stock is not available to the general public. Privately held companies, while accounting for the largest number of businesses and employment in the United States, are often smaller (based on value) than publicly traded companies. Whereas financial information and company stock of publicly traded companies are available to those inside and outside of the organization, financial information and company stock of privately held companies are often limited exclusively to employees at a certain level within the organization as a part of compensation and incentive packages or selectively to individuals or groups (such as banks or other lenders) outside the organization.

Publicly Held versus Privately Held Companies

Publicly Held Company	Privately Held Company
• Stock available to general public • Financial information public • Typically larger in value	• Stock not available to general public • Financial information private • Typically smaller in value

Table 1.1

Whether the stock is owned by a publicly traded or privately held company, owners use financial information to make decisions. Owners use the financial information to assess the financial performance of the business and make decisions such as whether or not to purchase additional stock, sell existing stock, or maintain the current level of stock ownership.

Other decisions stockholders make may be influenced by the type of company. For example, stockholders of privately held companies often are also employees of the company, and the decisions they make may be related to day-to-day activities as well as longer-term strategic decisions. Owners of publicly traded companies, on the other hand, will usually only focus on strategic issues such as the company leadership, purchases of other businesses, and executive compensation arrangements. In essence, stockholders predominantly focus on profitability, expected increase in stock value, and corporate stability.

Creditors and Lenders

In order to provide goods and services to their customers, businesses make purchases from other businesses. These purchases come in the form of materials used to make finished goods or resell, office equipment such as copiers and telephones, utility services such as heating and cooling, and many other products and services that are vital to run the business efficiently and effectively.

It is rare that payment is required at the time of the purchase or when the service is provided. Instead, businesses usually extend “credit” to other businesses. Selling and purchasing on credit, which is explored further in [Merchandising Transactions](#) and [Accounting for Receivables](#), means the payment is expected after a certain period of time following receipt of the goods or provision of the service. The term **creditor** refers to a business that grants extended payment terms to other businesses. The time frame for extended credit to other businesses for purchases of goods and services is usually very short, typically thirty-day to forty-five-day periods are common.

When businesses need to borrow larger amounts of money and/or for longer periods of time, they will often borrow money from a **lender**, a bank or other institution that has the primary purpose of lending money with a specified repayment period and stated interest rate. If you or your family own a home, you may already be familiar with lending institutions. The time frame for borrowing from lenders is typically measured in years rather than days, as was the case with creditors. While lending arrangements vary, typically the borrower is required to make periodic, scheduled payments with the full amount being repaid by a certain date. In addition, since the borrowing is for a long period of time, lending institutions require the borrower to pay a fee (called interest) for the use of borrowing. These concepts and the related accounting practices are covered in [Long-Term Liabilities](#). [Table 1.2](#) Summarizes the differences between creditors and lenders.

Creditor versus Lender

Creditor	Lender
• Business that grants extended payment terms to other businesses • Shorter time frame	• Bank or other institution that lends money • Longer time frame

Table 1.2

Both creditors and lenders use financial information to make decisions. The ultimate decision that both creditors and lenders have to make is whether or not the funds will be repaid by the borrower. The reason this is important is because lending money involves risk. The type of risk creditors and lenders assess is repayment risk—the risk the funds will not be repaid. As a rule, the longer the money is borrowed, the higher the risk involved.

Recall that accounting information is historical in nature. While historical performance is no guarantee of future performance (repayment of borrowed funds, in this case), an established pattern of financial performance using historical accounting information does help creditors and lenders to assess the likelihood the funds will be repaid, which, in turn, helps them to determine how much money to lend, how long to lend the money for, and how much interest (in the case of lenders) to charge the borrower.

Sources of Funding

Besides borrowing, there are other options for businesses to obtain or raise additional funding (also often labeled as capital). It is important for the business student to understand that businesses generally have three ways to raise capital: profitable operations is the first option; selling ownership—stock—which is also called equity financing, is the second option; and borrowing from lenders (called debt financing) is the final option.

In [Introduction to Financial Statements](#), you'll learn more about the business concept called "profit." You are already aware of the concept of profit. In short, profit means the inflows of resources are greater than the outflow of resources, or stated in more business-like terms, the revenues that the company generates are larger or greater than the expenses. For example, if a retailer buys a printer for \$150 and sells it for \$320, then from the sale it would have revenue of \$320 and expenses of \$150, for a profit of \$170. (Actually, the process is a little more complicated because there would typically be other expenses for the operation of the store. However, to keep the example simple, those were not included. You'll learn more about this later in the course.)

Developing and maintaining profitable operations (selling goods and services) typically provides businesses with resources to use for future projects such as hiring additional workers, maintaining equipment, or expanding a warehouse. While profitable operations are valuable to businesses, companies often want to engage in projects that are very expensive and/or are time sensitive. Businesses, then, have other options to raise funds quickly, such as selling stock and borrowing from lenders, as previously discussed.

An advantage of selling stock to raise capital is that the business is not committed to a specific payback schedule. A disadvantage of issuing new stock is that the administrative costs (legal and compliance) are high, which makes it an expensive way to raise capital.

There are two advantages to raising money by borrowing from lenders. One advantage is that the process,

relative to profitable operations and selling ownership, is quicker. As you've learned, lenders (and creditors) review financial information provided by the business in order to make assessments on whether or not to lend money to the business, how much money to lend, and the acceptable length of time to lend. A second, and related, advantage of raising capital through borrowing is that it is fairly inexpensive. A disadvantage of borrowing money from lenders is the repayment commitments. Because lenders require the funds to be repaid within a specific time frame, the risk to the business (and, in turn, to the lender) increases.

These topics are covered extensively in the area of study called corporate finance. While finance and accounting are similar in many aspects, in practicality finance and accounting are separate disciplines that frequently work in coordination in a business setting. Students may be interested to learn more about the educational and career options in the field of corporate finance. Because there are many similarities in the study of finance and accounting, many college students double major in a combination of finance, accounting, economics, and information systems.

CONCEPTS IN PRACTICE

Profit

What is profit? In accounting, there is general consensus on the definition of profit. A typical definition of profit is, in effect, when inflows of cash or other resources are greater than outflows of resources.

Ken Blanchard provides another way to define profit. Blanchard is the author of *The One Minute Manager*, a popular leadership book published in 1982. He is often quoted as saying, "profit is the applause you get for taking care of your customers and creating a motivating environment for your people [employees]." Blanchard's definition recognizes the multidimensional aspect of profit, which requires successful businesses to focus on their customers, employees, and the community.

Check out this [short video of Blanchard's definition of profit \(https://openstax.org/l/50Blanchard\)](https://openstax.org/l/50Blanchard) for more information. What are alternative approaches to defining profit?

Governmental and Regulatory Agencies

Publicly traded companies are required to file financial and other informational reports with the **Securities and Exchange Commission (SEC)**, a federal regulatory agency that regulates corporations with shares listed and traded on security exchanges through required periodic filings [Figure 1.6](#). The SEC accomplishes this in two primary ways: issuing regulations and providing oversight of financial markets. The goal of these actions is to help ensure that businesses provide investors with access to transparent and unbiased financial information.



Figure 1.6 Securities and Exchange Commission. (credit: "Seal of the United States Securities and Exchange Commission" by U.S. Government/Wikimedia Commons, Public Domain)

As an example of its responsibility to issue regulations, you learn in [Introduction to Financial Statements](#) that the SEC is responsible for establishing guidelines for the accounting profession. These are called accounting standards or generally accepted accounting principles (GAAP). Although the SEC also had the responsibility of issuing standards for the auditing profession, they relinquished this responsibility to the Financial Accounting Standards Board (FASB).

In addition, you will learn in [Describe the Varied Career Paths Open to Individuals with an Accounting Education](#) that auditors are accountants charged with providing reasonable assurance to users that financial statements are prepared according to accounting standards. This oversight is administered through the Public Company Accounting Oversight Board (PCAOB), which was established in 2002.

The SEC also has responsibility for regulating firms that issue and trade (buy and sell) securities—stocks, bonds, and other investment instruments.

Enforcement by the SEC takes many forms. According to the SEC website, "Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them."^[3] Financial information is a valuable tool that is part of the investigatory and enforcement activities of the SEC.

CONCEPTS IN PRACTICE

Financial Professionals and Fraud

You may have heard the name Bernard "Bernie" Madoff. Madoff ([Figure 1.7](#)) was the founder of an investment firm, **Bernard L. Madoff Investment Securities**. The original mission of the firm was to provide financial advice and investment services to clients. This is a valuable service to many people because of the complexity of financial investments and retirement planning. Many people rely on financial professionals, like Bernie Madoff, to help them create wealth and be in a position to retire comfortably. Unfortunately, Madoff took advantage of the trust of his investors and was ultimately convicted of stealing (embezzling) over \$50 billion (a low amount by some estimates). Madoff's embezzlement remains one of the biggest financial frauds in US history.

3 U.S. Securities and Exchange Commission. "What We Do." June 10, 2013. <https://www.sec.gov/Article/whatwedo.html>

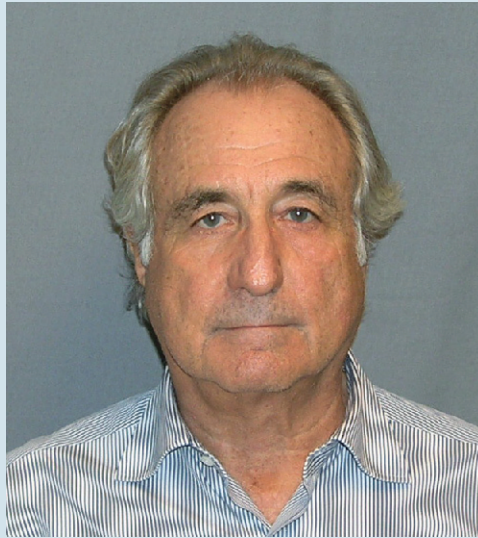


Figure 1.7 Bernie Madoff. Bernie Madoff's mug shot upon being arrested in March 2009. (credit: "BernardMadoff" by U.S. Department of Justice/Wikimedia Commons, Public Domain)

The fraud scheme was initially uncovered by a financial analyst named Harry Markopolos. Markopolos became suspicious because Madoff's firm purported to achieve for its investors abnormally high rates of return for an extended period of time. After analyzing the investment returns, Markopolos reported the suspicious activity to the Securities and Exchange Commission (SEC), which has enforcement responsibility for firms providing investment services. While Madoff was initially able to stay a few steps ahead of the SEC, he was charged in 2009 and will spend the rest of his life in prison.

There are many resources to explore the Madoff scandal. You might be interested in reading the book, *No One Would Listen: A True Financial Thriller*, written by Harry Markopolos. A movie and a TV series have also been made about the Madoff scandal.

In addition to governmental and regulatory agencies at the federal level, many state and local agencies use financial information to accomplish the mission of protecting the public interest. The primary goals are to ensure the financial information is prepared according to the relevant rules or practices as well as to ensure funds are being used in an efficient and transparent manner. For example, local school district administrators should ensure that financial information is available to the residents and is presented in an unbiased manner. The residents want to know their tax dollars are not being wasted. Likewise, the school district administrators want to demonstrate they are using the funding in an efficient and effective manner. This helps ensure a good relationship with the community that fosters trust and support for the school system.

Customers

Depending on the perspective, the term *customers* can have different meanings. Consider for a moment a retail store that sells electronics. That business has customers that purchase its electronics. These customers are considered the end users of the product. The customers, knowingly or unknowingly, have a stake in the financial performance of the business. The customers benefit when the business is financially successful. Profitable businesses will continue to sell the products the customers want, maintain and improve the

business facilities, provide employment for community members, and undertake many other activities that contribute to a vibrant and thriving community.

Businesses are also customers. In the example of the electronics store, the business purchases its products from other businesses, including the manufacturers of the electronics. Just as end-user customers have a vested interest in the financial success of the business, business customers also benefit from suppliers that have financial success. A supplier that is financially successful will help ensure the electronics will continue to be available to purchase and resell to the end-use customer, investments in emerging technologies will be made, and improvements in delivery and customer service will result. This, in turn, helps the retail electronics store remain cost competitive while being able to offer its customers a wide variety of products.

Managers and Other Employees

Employees have a strong interest in the financial performance of the organizations for which they work. At the most basic level, employees want to know their jobs will be secure so they can continue to be paid for their work. In addition, employees increase their value to the organization through their years of service, improving knowledge and skills, and accepting positions of increased responsibility. An organization that is financially successful is able to reward employees for that commitment to the organization through bonuses and increased pay.

In addition to promotional and compensation considerations, managers and others in the organization have the responsibility to make day-to-day and long-term (strategic) decisions for the organization. Understanding financial information is vital to making good organizational decisions.

Not all decisions, however, are based on strictly financial information. Recall that managers and other decision makers often use nonfinancial, or managerial, information. These decisions take into account other relevant factors that may not have an immediate and direct link to the financial reports. It is important to understand that sound organizational decisions are often (and should be) based on both financial and nonfinancial information.

In addition to exploring managerial accounting concepts, you will also learn some of the common techniques that are used to analyze the financial reports of businesses. [Appendix A](#) further explores these techniques and how stakeholders can use these techniques for making financial decisions.

IFRS CONNECTION

Introduction to International Financial Reporting Standards (IFRS)

In the past fifty years, rapid advances in communications and technology have led the economy to become more global with companies buying, selling, and providing services to customers all over the world. This increase in globalization creates a greater need for users of financial information to be able to compare and evaluate global companies. Investors, creditors, and management may encounter a need to assess a company that operates outside of the United States.

For many years, the ability to compare financial statements and financial ratios of a company headquartered in the United States with a similar company headquartered in another country, such as Japan, was challenging, and only those educated in the accounting rules of both countries could easily

handle the comparison. Discussions about creating a common set of international accounting standards that would apply to all publicly traded companies have been occurring since the 1950s and post-World War II economic growth, but only minimal progress was made. In 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began working more closely together to create a common set of accounting rules. Since 2002, the two organizations have released many accounting standards that are identical or similar, and they continue to work toward unifying or aligning standards, thus improving financial statement comparability between countries.

Why create a common set of international standards? As previously mentioned, the global nature of business has increased the need for comparability across companies in different countries. Investors in the United States may want to choose between investing in a US-based company or one based in France. A US company may desire to buy out a company located in Brazil. A Mexican-based company may desire to borrow money from a bank in London. These types of activities require knowledge of financial statements. Prior to the creation of IFRS, most countries had their own form of generally accepted accounting principles (GAAP). This made it difficult for an investor in the United States to analyze or understand the financials of a France-based company or for a bank in London to know all of the nuances of financial statements from a Mexican company. Another reason common international rules are important is the need for similar reporting for similar business models. For example, **Nestlé** and the **Hershey Company** are in different countries yet have similar business models; the same applies to **Daimler** and **Ford Motor Company**. In these and other instances, despite the similar business models, for many years these companies reported their results differently because they were governed by different GAAP—**Nestlé** by French GAAP, **Daimler** by German GAAP, and both the **Hershey Company** and **Ford Motor Company** by US GAAP. Wouldn't it make sense that these companies should report the results of their operations in a similar manner since their business models are similar? The globalization of the economy and the need for similar reporting across business models are just two of the reasons why the push for unified standards took a leap forward in the early twenty-first century.

Today, more than 120 countries have adopted all or most of IFRS or permit the use of IFRS for financial reporting. The United States, however, has not adopted IFRS as an acceptable method of GAAP for financial statement preparation and presentation purposes but has worked closely with the IASB. Thus, many US standards are very comparable to the international standards. Interestingly, the Securities and Exchange Commission (SEC) allows foreign companies that are traded on US exchanges to present their statements under IFRS rules without restating to US GAAP. This occurred in 2009 and was an important move by the SEC to show solidarity toward creating financial statement comparability across countries.

Throughout this text, “IFRS Connection” feature boxes will discuss the important similarities and most significant differences between reporting using US GAAP as created by FASB and IFRS as created by IASB. For now, know that it is important for anyone in business, not just accountants, to be aware of some of the primary similarities and differences between IFRS and US GAAP, because these differences can impact analysis and decision-making.

1.5 Describe the Varied Career Paths Open to Individuals with an Accounting Education

There are often misunderstandings on what exactly accountants do or what attributes are necessary for a

successful career in accounting. Often, people perceive accountants as “number-crunchers” or “bean counters” who sit behind a desk, working with numbers, and having little interaction with others. The fact is that this perception could not be further from the truth.

Personal Attributes

While it is true that accountants often work independently, much of the work that accountants undertake involves interactions with other people. In fact, accountants frequently need to gather information from others and explain complex financial concepts to others, making excellent written and verbal communication skills a must. In addition, accountants often deal with strict deadlines such as tax filings, making prioritizing work commitments and being goal oriented necessities. In addition to these skills, traditionally, an accountant can be described as someone who

- is goal oriented,
- is a problem solver,
- is organized and analytical,
- has good interpersonal skills,
- pays attention to detail,
- has good time-management skills, and
- is outgoing.

The Association of Chartered Certified Accountants (ACCA), the governing body of the global Chartered Certified Accountant (CCA) designation, and the Institute of Management Accountants (IMA), the governing body of the Certified Management Accountant (CMA) designation, conducted a study to research the skills accountants will need given a changing economic and technological context. The findings indicate that, in addition to the traditional personal attributes, accountants should possess “traits such as entrepreneurship, curiosity, creativity, and strategic thinking.”^[4]

Education

Entry-level positions in the accounting profession usually require a minimum of a bachelor’s degree. For advanced positions, firms may consider factors such as years of experience, professional development, certifications, and advanced degrees, such as a master’s or doctorate. The specific factors regarding educational requirements depend on the industry and the specific business.

After earning a bachelor’s degree, many students decide to continue their education by earning a master’s degree. A common question for students is when to begin a master’s program, either entering a master’s program immediately after earning a bachelor’s degree or first entering the profession and pursuing a master’s at a later point. On one hand, there are benefits of entering into a master’s program immediately after earning a bachelor’s degree, mainly that students are already into the rhythm of being a full-time student so an additional year or so in a master’s program is appealing. On the other hand, entering the profession directly after earning a bachelor’s degree allows the student to gain valuable professional experience that may enrich the graduate education experience. When to enter a graduate program is not an easy decision. There are pros and cons to either position. In essence, the final decision depends on the personal perspective and alternatives available to the individual student. For example, one student might not

4 The Association of Chartered Certified Accountants (ACCA) and The Association of Accountants and Financial Professionals in Business (IMA). “100 Drivers of Change for the Global Accountancy Profession.” September 2012. <https://www.imanet.org/insights-and-trends/the-future-of-management-accounting/100-drivers-of-change-for-the-global-accountancy-profession?ssopc=1>

have the financial resources to continue immediately on to graduate school and will first need to work to fund additional education, while another student might have outside suppliers of resources or is considering taking on additional student loan debt. The best recommendation for these students is to consider all of the factors and realize that they must make the final decision as to their own best alternative. It is also important to note that if one makes the decision to enter public accounting, as all states require 150 hours of education to earn a Certified Public Accountant (CPA) license, it is customary for regional and national public accounting firms to require a master's degree or 150 hours earned by other means as a condition for employment; this may influence your decision to enter a master's degree program as soon as the bachelor's degree is complete.

Related Careers

An accounting degree is a valuable tool for other professions too. A thorough understanding of accounting provides the student with a comprehensive understanding of business activity and the importance of financial information to make informed decisions. While an accounting degree is a necessity to work in the accounting profession, it also provides a solid foundation for other careers, such as financial analysts, personal financial planners, and business executives. The number of career options may seem overwhelming at this point, and a career in the accounting profession is no exception. The purpose of this section is to simply highlight the vast number of options that an accounting degree offers. In the workforce, accounting professionals can find a career that best fits their interests.

Students may also be interested in learning more about professional certifications in the areas of financial analysis (Chartered Financial Analyst) and personal financial planning (Certified Financial Planner), which are discussed later in this section.

Major Categories of Accounting Functions

It is a common perception that an accounting career means preparing tax returns. While numerous accountants do prepare tax returns, many people are surprised to learn of the variety of career paths that are available within the accounting profession. An accounting degree is a valuable tool that gives accountants a high level of flexibility and many options. Often individual accountants apply skills in several of the following career paths simultaneously. [Figure 1.8](#) illustrates some of the many career paths open to accounting students.



Figure 1.8 Career Paths. There are many career paths open to students of accounting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Auditing

Auditing, which is performed by accountants with a specialized skill set, is the process of ensuring activities are carried out as intended or designed. There are many examples of the functions that auditors perform. For example, in a manufacturing company, auditors may sample products and assess whether or not the products conform to the customer specifications. As another example, county auditors may test pumps at gas stations to ensure the pumps are delivering the correct amount of gasoline and charging customers correctly.

Companies should develop policies and procedures to help ensure the company's goals are being met and the assets are protected. This is called the internal control system. To help maintain the effectiveness of the internal control system, companies often hire internal auditors, who evaluate internal controls through reviews and tests. For example, internal auditors may review the process of how cash is handled within a business. In this scenario, the goal of the company is to ensure that all cash payments are properly applied to customer accounts and that all funds are properly deposited into the company's bank account. As another example, internal auditors may review the shipping and receiving process to ensure that all products shipped or received have the proper paperwork and the product is handled and stored properly. While internal auditors also often work to ensure compliance with external regulations, the primary goal of internal auditors is to help ensure the company policies are followed, which helps the company attain its strategic goals and protect its assets. The professional certification most relevant to a career in internal audit is the Certified Internal Auditor (CIA). Financial fraud occurs when an individual or individuals act with intent to deceive for a financial gain. A Certified Fraud Examiner (CFE) is trained to prevent fraud from occurring and to detect when fraud has occurred. A thorough discussion of the internal control system and the role of accountants occurs in [Fraud, Internal Controls, and Cash](#).

Companies also want to ensure the financial statements provided to outside parties such as banks, governmental agencies, and the investing public are reliable and consistent. That is, companies have a desire to provide financial statements that are free of errors or fraud. Since internal auditors are committed to providing unbiased financial information, it would be possible for the company to use internal auditors to attest to the integrity of the company's financial statements. With that said, doing so presents the appearance

of a *possibility* of a conflict of interest and could call into question the validity of the financial statements. Therefore, companies hire external auditors to review and attest to the integrity of the financial statements. External auditors typically work for a public accounting firm. Although the public accounting firm is hired by the company to attest to the fairness of the financial statements, the external auditors are independent of the company and provide an unbiased opinion.

Taxation

There are many taxes that businesses are required to pay. Examples include income taxes, payroll and related taxes such as workers' compensation and unemployment, property and inventory taxes, and sales and use taxes. In addition to making the tax payments, many of the taxes require tax returns and other paperwork to be completed. Making things even more complicated is the fact that taxes are levied at the federal, state, and local levels. For larger worldwide companies, the work needed to meet their international tax compliance requirements can take literally thousands of hours of accountants' time. To sum up the process, the goal of tax accountants is to help ensure the taxes are paid properly and in a timely manner, from an individual level all the way to the company level (including at the level of such companies as **Apple** and **Walmart**).

Since accountants have an understanding of various tax laws and filing deadlines, they are also well-positioned to offer tax planning advice. Tax laws are complex and change frequently; therefore, it is helpful for businesses to include tax considerations in their short- and long-term planning. Accountants are a valuable resource in helping businesses minimize the tax liability.

Many businesses find it necessary to employ accountants to work on tax compliance and planning on a full-time basis. Other businesses need these services on a periodic (quarterly or annual) basis and hire external accountants accordingly.

Financial Accounting

Financial accounting measures, in dollars, the activities of an organization. Financial accounting is historical in nature and is prepared using standard conventions, called accounting standards or GAAP. Because nearly every activity in an organization has a financial implication, financial accounting might be thought of as a "monetary scorecard."

Financial accounting is used internally by managers and other decision makers to validate activities that were done well and to highlight areas that need adjusted in the future. Businesses often use discretion as to how much and with whom financial accounting information is shared.

Financial accounting is also provided to those outside the organization. For a publicly traded company, issuing financial statements is required by the SEC. Sharing financial information for a privately held company is usually reserved for those instances where the information is required, such as for audits or obtaining loans.

Consulting

Because nearly every activity within an organization has a financial implication, accountants have a unique opportunity to gain a comprehensive view of an organization. Accountants are able to see how one area of a business affects a different aspect of the business. As accountants gain experience in the profession, this unique perspective allows them to build a "knowledge database" that is valuable to businesses. In this capacity, accountants can provide **consulting** services, which means giving advice or guidance to managers and other decision makers on the impact (both financial and nonfinancial) of a potential course of action. This role allows the organization to gain knowledge from the accountants in a way that minimizes risk and/or

financial investment.

As discussed previously, accountants may advise a business on tax-related issues. Other examples of consultative services that accountants perform include selection and installation of computer software applications and other technology considerations, review of internal controls, determination of compliance with relevant laws and regulations, review of compensation and incentive arrangements, and consideration of operational efficiencies within the production process.

Accounting Information Services

Computers are an integral part of business. Computers and related software programs allow companies to efficiently record, store, and process valuable data and information relevant to the business. Accountants are often an integral part of the selection and maintenance of the company's computerized accounting and information system. The goal of the accounting information system is to efficiently provide relevant information to internal decision makers, and it is important for businesses to stay abreast of advances in technology and invest in those technologies that help the business remain efficient and competitive.

Significant growth is expected in accounting information systems careers. According to the US Bureau of Labor Statistics, in 2010 there were over 130,000 jobs in the accounting informations systems sector, with over 49% growth expected through 2024. Median earnings in this field were over \$73,000 in 2011.^[5] For those interested in both accounting and computer information systems, there are tremendous career opportunities.

CONCEPTS IN PRACTICE

Enterprise Resource Planning

As companies grow in size and expand geographically, it is important to assess whether or not a current computerized system is *the right size and fit* for the organization. For example, a company with a single location can easily manage its business activities with a small, off-the-shelf software package such as **QuickBooks** and software applications such as **Microsoft** Excel. A company's computer system becomes more complex when additional locations are added.

5 Lauren Csorny. "Careers in the Growing Field of Information Technology Services." Bureau of Labor Statistics/U.S. Department of Labor. April 2013. <https://www.bls.gov/opub/btn/volume-2/careers-in-growing-field-of-information-technology-services.htm>



Figure 1.9 Growth. (credit: "Statistics Arrows Trends" by "geralt"/Pixabay, CC0)

As companies continue to grow, larger integrated computer systems, called enterprise resource planning (ERP) systems, may be implemented. Enterprise resource planning systems are designed to maintain the various aspects of the business within a single integrated computer system. For example, a leading ERP system is **Microsoft** Dynamics GP. **Microsoft** Dynamics GP is an integrated system with the capability to handle the human resource management, production, accounting, manufacturing, and many other aspects of a business. ERP systems, like **Microsoft** Dynamics GP, are also designed to accommodate companies that have international locations. The benefit of ERP systems is that information is efficiently stored and utilized across the entire business in real time.

Cost and Managerial Accounting

Cost accounting and managerial accounting are related, but different, types of accounting. In essence, a primary distinction between the two functions is that cost accounting takes a primarily quantitative approach, whereas managerial accounting takes both quantitative and qualitative approaches. The goal of cost accounting is to determine the costs involved with providing goods and services. In a manufacturing business, **cost accounting** is the recording and tracking of costs such as direct materials, employee wages, and supplies used in the manufacturing process.

Managerial accounting uses cost accounting and other financial accounting information, as well as nonfinancial information, to make short-term as well as strategic and other long-term decisions for a business.

Both cost and managerial accounting are intended to be used inside a business. Along with financial accounting information, managers and other decision makers within a business use the information to facilitate decision-making, develop long-term plans, and perform other functions necessary for the success of the business.

There are two major differences between cost and managerial accounting and financial accounting. Whereas financial accounting requires the use of standard accounting conventions (also called accounting standards or GAAP), there are no such requirements for cost and managerial accounting. In practice, management has different needs that require cost and managerial accounting information. In addition, financial information is prepared in specific intervals of time, usually monthly. The same is not true with cost and managerial

accounting, which are prepared on an as-needed basis that is not reported as specific periods of time.

An example may be helpful in clarifying the difference between cost and managerial accounting.

Manufacturing companies often face the decision of whether to make certain components or purchase the components from an outside supplier. Cost accounting would calculate the cost of each alternative.

Managerial accounting would use that cost and supplement the cost with nonfinancial information to arrive at a decision. Let's say the cost accountants determine that a company would save \$0.50 per component if the units were purchased from an outside supplier rather than being produced by the company. Managers would use the \$0.50 per piece savings as well as nonfinancial considerations, such as the impact on the morale of current employees and the supplier's ability to produce a quality product, to make a decision whether or not to purchase the component from the outside supplier.

In summary, it may be helpful to think of cost accounting as a subset of managerial accounting. Another way to think about cost and managerial accounting is that the result of cost accounting is a number, whereas the result of managerial accounting is a decision.

Financial Planning

While accountants spend much of their time interacting with other people, a large component of their work involves numbers and finances. As mentioned previously, many people with an interest in data often go into the accounting profession and have a natural inclination toward solving problems. In addition, accountants also gain a comprehensive view of business. They understand how the diverse aspects of the business are connected and how those activities ultimately have a financial impact on the organization.

These attributes allow accountants to offer expertise in financial planning, which takes many forms. Within a business, making estimates and establishing a plan for the future—called a budget—are vital. These actions allow the business to determine the appropriate level of activity and make any adjustments accordingly.

Training in accounting is also helpful for those who offer financial planning for individuals. When it comes to investing and saving for the future, there are many options available to individuals. Investing is complicated, and many people want help from someone who understands the complexities of the investment options, the tax implications, and ways to invest and build wealth. Accountants are well trained to offer financial planning services to the businesses they work with as well as individuals investing for their future.

Entrepreneurship

Many people have an idea for a product or service and decide to start their own business—they are often labeled as entrepreneurs. These individuals have a passion for their product or service and are experts at what they do. But that is not enough. In order for the business to be successful, the entrepreneur must understand all aspects of the business, including and especially the financial aspect. It is important for the entrepreneur to understand how to obtain the funding to start the business, measure the financial performance of the business, and know what adjustments to improve the performance of the business are necessary and when to make them. Understanding accounting, or hiring accountants who can perform these activities, is valuable to the entrepreneur. An entrepreneur works extremely hard and has often taken a great risk in starting his or her own business. Understanding the financial performance of the business helps ensure the business is successful.

CONCEPTS IN PRACTICE

Entrepreneurship

Entrepreneurs do not have to develop a brand new product or service in order to open their own business. Often entrepreneurs decide to purchase a store from a business that already exists. This is called a franchise arrangement. In these arrangements, the business owner (the franchisee) typically pays the franchisor (the business offering the franchise opportunity) a lump sum at the beginning of the arrangement. This lump sum payment allows the franchisee an opportunity to use the store logos and receive training, consulting, and other support from the franchisor. A series of scheduled payments is also common. The ongoing payments are often based on a percentage of the franchise store's sales.

The franchise arrangement is beneficial to both parties. For the franchisee, there is less risk involved because they often purchase a franchise from a business with an established track record of success. For the franchisor, it is an opportunity to build the brand without the responsibility of direct oversight for individual stores—each franchise is independently owned and operated (a phrase you might see on franchise stores).

The downside of the franchising arrangement is the amount of money that is paid to the franchisor through the initial lump sum as well as continued payments. These costs, however, are necessary for the ongoing support from the franchisor. In addition, franchisees often have restrictions relative to product pricing and offerings, geographic locations, and approved suppliers.

According to Entrepreneur.com, based on factors such as costs and fees, support, and brand strength, the number one-ranking franchise in 2017 was **7-Eleven, Inc.** According to the website, **7-Eleven** has been franchising since 1964 and has 61,086 franchise stores worldwide (7,025 are located in the United States). In addition, **7-Eleven** has 1,019 company-owned stores.^[6]

Major Categories of Employers

Now that you've learned about the various career paths that accountants can take, let's briefly look at the types of organizations that accountants can work for. [Figure 1.10](#) illustrates some common types of employers that require accountants. While this is not an all-inclusive list, most accountants in the profession are employed by these types of organizations.

6 "7-Eleven." Entrepreneur.com. n.d. <https://www.entrepreneur.com/franchises/7eleveninc/282052>

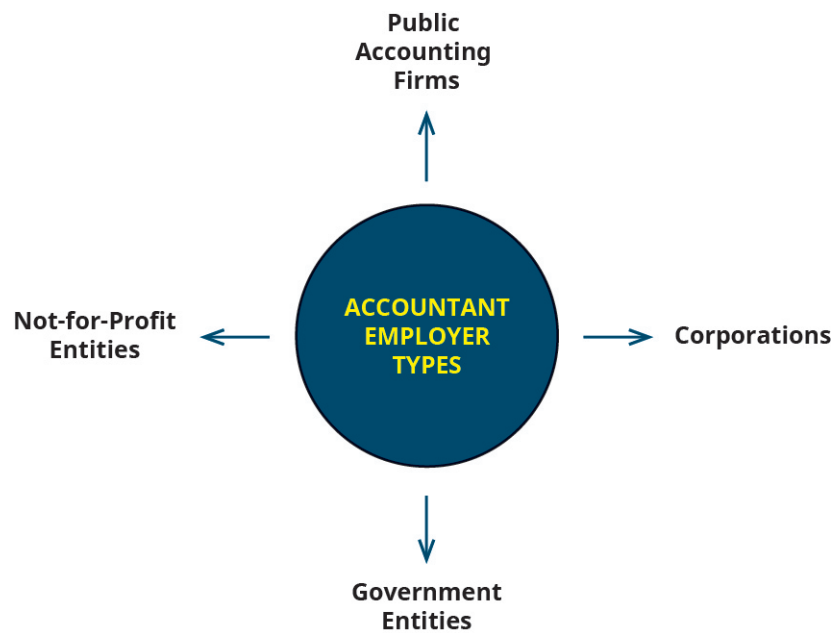


Figure 1.10 Accountant Employer Types. Accountants may find employment within a variety of types of entities. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Public Accounting Firms

Public accounting firms offer a wide range of accounting, auditing, consulting, and tax preparation services to their clients. A small business might use a public accounting firm to prepare the monthly or quarterly financial statements and/or the payroll. A business (of any size) might hire the public accounting firm to audit the company financial statements or verify that policies and procedures are being followed properly. Public accounting firms may also offer consulting services to their clients to advise them on implementing computerized systems or strengthening the internal control system. (Note that you will learn in your advanced study of accounting that accountants have legal limitations on what consulting services they can provide to their clients.) Public accounting firms also offer tax preparation services for their business and individual clients. Public accounting firms may also offer business valuation, forensic accounting (financial crimes), and other services.

Public accounting firms are often categorized based on the size (revenue). The biggest firms are referred to as the “Big Four” and include **Deloitte Touche Tohmatsu Limited (DTTL)**, **PricewaterhouseCoopers (PwC)**, **Ernst & Young (EY)**, and **KPMG**. Following the Big Four in size are firms such as **RSM US**, **Grant Thornton**, **BDO USA**, **Crowe**, and **CliftonLarsonAllen (CLA)**.^[7] There are also many other regional and local public accounting firms.

Public accounting firms often expect the accountants they employ to have earned (or will earn) the Certified Public Accountant (CPA) designation. It is not uncommon for public accounting firms to specialize. For example, some public accounting firms may specialize in serving clients in the banking or aerospace industries. In addition to specializing in specific industries, public accounting firms may also specialize in areas of accounting such as tax compliance and planning.

Hiring public accounting firms to perform various services is an attractive option for many businesses. The primary benefit is that the business has access to experts in the profession without needing to hire accounting

7 “2017 Top 100 Firms.” *Accounting Today*. 2017. https://lscpagepro.mydigitalpublication.com/publication/?i=390208#{%22issue_id%22:390208,%22page%22:0}

specialists on a full-time basis.

Corporations

Corporations hire accountants to perform various functions within the business. The primary responsibility of corporate accountants (which include cost and managerial accountants) is to provide information for internal users and decision makers, as well as implement and monitor internal controls. The information provided by corporate accountants takes many forms. For example, some of the common responsibilities of corporate accountants include calculating and tracking the costs of providing goods and services, analyzing the financial performance of the business in comparison to expectations, and developing budgets, which help the company plan for future operations and make any necessary adjustments. In addition, many corporate accountants have the responsibility for or help with the company's payroll and computer network.

In smaller corporations, an accountant may be responsible for or assist with several of these activities. In larger firms, however, accountants may specialize in one of the areas of responsibilities and may rotate responsibilities throughout their career. Many larger firms also use accountants as part of the internal audit function. In addition, many large companies are able to dedicate resources to making the organization more efficient. Programs such as Lean Manufacturing and Six Sigma focus on reducing waste and eliminating cost within the organization. Accountants trained in these techniques receive specialized training that focuses on the cost impact of the activities of the business.

As with many organizations, professional certifications are highly valued in corporations. The primary certification for corporate accounting is the Certified Management Accountant (CMA). Because corporations also undertake financial reporting and related activities, such as tax compliance, corporations often hire CPAs.

Governmental Entities

Accountants in governmental entities perform many of the same functions as accountants in public accounting firms and corporations. The primary goal of **governmental accounting** is to ensure proper tracking of the inflows and outflows of taxpayer funds using the proscribed standards. Some governmental accountants also prepare and may also audit the work of other governmental agencies to ensure the funds are properly accounted for. The major difference between accountants in governmental entities and accountants working in public accounting firms and corporations relates to the specific rules by which the financial reporting must be prepared. Whereas accountants in public accounting firms and corporations use GAAP, governmental accounting is prepared under a different set of rules that are specific to governmental agencies, as previously referred to as the Governmental Accounting Standards Board (GASB). Students continuing their study of accounting may take specific courses related to governmental accounting.

Accountants in the governmental sector may also work in specialized areas. For example, many accountants work for tax agencies at the federal, state, and local levels to ensure the tax returns prepared by businesses and individuals comply with the tax code appropriate for the particular jurisdiction. As another example, accountants employed by the SEC may investigate instances where financial crimes occur, as in the case of Bernie Madoff, which was discussed in [Concepts in Practice: Financial Professionals and Fraud](#).

CONCEPTS IN PRACTICE

Bringing Down Capone

Al Capone was one of the most notorious criminals in American history. Born in 1899 in Brooklyn, New York, Al Capone rose to fame as a gangster in Chicago during the era of Prohibition. By the late 1920s–1930s, Capone controlled a syndicate with a reported annual income of \$100 million.

Al Capone was credited for many murders, including masterminding the famous 1929 St. Valentine's Day murder, which killed seven rival gang members. But law enforcement was unable to convict Capone for the murders he committed or orchestrated. Through bribes and extortion, Capone was able to evade severe punishment, being charged at one point with gun possession and serving a year in jail.

Capone's luck ran out in 1931 when he was convicted of federal tax evasion. In 1927, the United States Supreme Court ruled that earnings from illegal activities were taxable. Capone, however, did not claim the illegal earnings on his 1928 and 1929 income tax returns and was subsequently sentenced to eleven years in prison. Up to that point, it was the longest-ever sentence for tax evasion.

Al Capone was paroled from prison in November 1939 and died on January 25, 1947. His life has been the subject of many articles, books, movies including *Scarface* (1932), and the TV series *The Untouchables* (1993).

Those interested in stories like this might consider working for the Federal Bureau of Investigation (FBI). According to the FBI, as of 2012, approximately 15% of FBI agents are special agent accountants.

1 Copy of 4 post. sent to: 3rd Jacksonville 10-25-32

DEPARTMENT OF JUSTICE, BUREAU OF INVESTIGATION
IDENTIFICATION DIVISION, WASHINGTON, D. C.

Station: S. Penitentiary, Atlanta, Ga. Located at: _____

Received: MAY 4 1932

From: N. Ill. - Chicago

Crime: Vis. Income Tax Laws

Sentence: 10 yrs. — mos. — days

Date of sentence: Oct 24 - 1931

Sentence begins: May 4 - 1932

Sentence expires: May 3 - 1942

Good time sentence expires: Jan 19 - 1939

Date of birth: 1-17-99 Occupation: Gambler

Birthplace: NY Nationality: _____

Age: 33 Complexion: Fair

Height: 5-10 1/2 Eyes: Grey

Weight: 255 Hair: Dark brown

Build: Stout

Scars and marks: oblique scar of 4" across cheek 2" in front Left ear - Vertical scar of 2 1/2" on left jaw - oblique scar of 2 1/2" - 2" under left ear on neck

K4805

40886

CRIMINAL HISTORY

NAME	NUMBER	CITY OR INSTITUTION	DATE	CHARGE	DISPOSITION OR SENTENCE
C		NY City	1919	Dis Cond	Discharged
D		Chicago Ill	1923	Traffic	Dismissed
E		Do	5-8-24	Murder Wit	Released
H		Do	6-7-26	Vis NPA	Dismissed
I		Do	7-28-26	Murder	Charge Withdrawn
J		Do	10-1-26	Vis NPA	Dismissed
K		Do	11-12-27	Refus. to testify	Do
L		Police Ill	12-22-27	Car weap	Fined 26.00. on
M		Phila. Pa	5-17-29	Do	Served 12 mos.
		Miami Fla	1928	Do	Release
		Do	5-8-30	Do	Do

(Please see additional criminal history and police record)

Figure 1.11 Al Capone. The FBI's 1932 criminal record on Al Capone shows the many charges against him, most of which were dismissed. (credit: modification of "Capone's criminal record in 1932" by FBI/ United States Bureau of Prisons/Wikimedia Commons, Public Domain)

Not-for-Profit Entities, Including Charities, Foundations, and Universities

Not-for-profit entities include charitable organizations, foundations, and universities. Unlike for-profit entities, not-for-profit organizations have a primary focus of a particular mission. Therefore, **not-for-profit (NFP) accounting** helps ensure that donor funds are used for the intended mission. Much like accountants in governmental entities, accountants in not-for-profit entities use a slightly different type of accounting than other types of businesses, with the primary difference being that not-for-profit entities typically do not pay income taxes.

However, even if a not-for-profit organization is not subjected to income taxes in a particular year, it generally must file informational returns, such as a Form 990, with the Internal Revenue Service (IRS). Information, such

as sources and amounts of funding and major types and amounts of expenditures, is documented by the not-for-profit entities to provide information for potential and current donors. Once filed with the IRS, Form 990 is available for public view so that the public can monitor how the specific charity uses proceeds as well as its operational efficiency.

Potential Certifications for Accountants

As previously discussed, the study of accounting serves as a foundation for other careers that are similar to accounting, and the certifications described here reflect that relationship.

There are many benefits to attaining a professional certification (or multiple certifications) in addition to a college degree. Certifications often cover material at a deeper and more complex level than might typically be covered in a college program. Those earning a professional certification demonstrate their willingness to invest the additional time and energy into becoming experts in the particular field. Because of this, employees with professional certifications are often in higher demand and earn higher salaries than those without professional certifications. Companies also benefit by having employees with professional certifications. A well-trained staff with demonstrated expertise conveys a level of professionalism that gives the organization a competitive advantage. In addition, professional certifications often require a certain number of hours of ongoing training. This helps ensure that the certificate holder remains informed as to the current advances within the profession and benefits both the employee and the employer.

Certifications are developed and governed by the respective governing body. Each issuing body establishes areas of content and requirements for the specific certification. Links to the particular websites are provided so you can easily gain additional information.

It is also important to note that many of the certifications have review courses available. The review courses help students prepare for the exam by offering test-taking strategies, practice questions and exams, and other materials that help students efficiently and effectively prepare for the exams.

ETHICAL CONSIDERATIONS

Accounting Codes of Ethics

In the United States, accountants can obtain a number of different certifications and can be licensed by each state to practice as a Certified Public Accountant (CPA). Accountants can also belong to professional organizations that have their own codes of conduct. As the online Stanford Encyclopedia of Philosophy explains, “many people engaged in business activity, including accountants and lawyers, are professionals. As such, they are bound by codes of conduct promulgated by professional societies. Many firms also have detailed codes of conduct, developed and enforced by teams of ethics and compliance personnel.”^[8] CPAs can find a code of ethics in each state of practice and with the AICPA.^[9] Certifications such as the CMA, CIA, CFE, CFA, and CFP each have their own codes of ethics.

To facilitate cross-border business activities and accounting, an attempt has been made to set international standards. To this end, accounting standards organizations in more than 100 countries use the International Federation of Accountants’ (IFAC) Code of Ethics for Professional Accountants.”^[10]

When auditing a public company, CPAs may also have to follow a special code of ethics created by the Public Company Accounting Oversight Board (PCAOB), or when performing federal tax work, the US Treasury Department's Circular No. 230 code of ethics. These are just some examples of ethical codes that are covered in more detail in this course. Each area of accounting work has its own set of ethical rules, but they all require that a professional accountant perform his or her work with integrity.

Certified Public Accountant (CPA)

The Certified Public Accountant (CPA) designation is earned after passing a uniform exam issued by the American Institute of Certified Public Accountants (AICPA). While the exam is a uniform, nationally administered exam, each state issues and governs CPA licenses.

The CPA exam has four parts: Auditing and Attestation (AUD), Business Environment and Concepts (BEC), Financial Accounting and Reporting (FAR), and Regulation (REG). A score of at least 75% must be earned in order to earn the CPA designation.

Since each state determines the requirements for CPA licenses, students are encouraged to check the state board of accountancy for specific requirements. In Ohio, for example, candidates for the CPA exam must have 150 hours of college credit. Of those, thirty semester hours (or equivalent quarter hours) must be in accounting. Once the CPA designation is earned in Ohio, 120 hours of continuing education must be taken over a three-year period in order to maintain the certification. The requirements for the Ohio CPA exam are similar to the requirements for other states. Even though states issue CPA licenses, a CPA will not lose the designation should he or she move to another state. Each state has mobility or reciprocity requirements that allow CPAs to transfer licensure from one state to another. Reciprocity requirements can be obtained by contacting the respective state board of accountancy.

The majority of states require 150 hours of college credit. Students often graduate with a bachelor's degree with approximately 120–130 credit hours. In order to reach the 150-hour requirement that specific states have, students have a couple of options. The extra hours can be earned either by taking additional classes in their undergraduate program or by entering a graduate program, earning a master's degree. Master's degrees that would be most beneficial in an accounting or related field would be a master of accountancy, master in taxation, or a master in analytics, which is rapidly increasing in demand.

LINK TO LEARNING

Information about the Certified Public Accountant (CPA) exam is provided by the following:

- [the American Institute of Certified Public Accountants \(AICPA\) \(https://openstax.org/l/50AICPA_CPA\)](https://openstax.org/l/50AICPA_CPA)
- [the National Association of State Boards of Accountancy \(NASBA\) \(https://openstax.org/l/\)](https://openstax.org/l/)

8 Jeffrey Moriarty. "Business Ethics." Stanford Encyclopedia of Philosophy. November 17, 2016. <https://plato.stanford.edu/entries/ethics-business/>

9 American Institute of Certified Public Accountants (AICPA). "AICPA Code of Professional Conduct." n.d. <https://www.aicpa.org/research/standards/codeofconduct.html>

10 Catherine Allen and Robert Bunting. "A Global Standard for Professional Ethics: Cross-Border Business Concerns." May 2008. https://www.ifrs.com/overview/Accounting_Firms/Global_Standard.html

[50NASBA_CPA\)](#)

- [This Way to CPA \(https://openstax.org/l/50ThisWayCPA\)](https://openstax.org/l/50ThisWayCPA)

Certified Management Accountant (CMA)

The Certified Management Accountant (CMA) exam is developed and administered by the Institute of Management Accountants (IMA). There are many benefits in earning the CMA designation, including career advancement and earnings potential. Management accountants, among other activities, prepare budgets, perform analysis of financial and operational variances, and determine the cost of providing goods and services. Earning a certification enables the management accountant to advance to management and executive positions within the organization.

The CMA exam has two parts: Financial Reporting, Planning, Performance, and Control (part 1) and Financial Decision-Making (part 2). A score of at least 72% must be earned in order to earn the CMA designation. A minimum of a bachelor's degree is required to take the CMA exam. An accounting degree or a specific number of credit hours in accounting is not required in order to take the CMA exam. Once the CMA designation is earned, thirty hours of continuing education with two of the hours focusing on ethics must be taken annually in order to maintain the certification.

LINK TO LEARNING

Visit the Institute of Management Accountants (IMA)'s page on [the Certified Management Accountant \(CMA\) exam and certification \(https://openstax.org/l/50CMAExamIMA\)](https://openstax.org/l/50CMAExamIMA) to learn more.

Certified Internal Auditor (CIA)

The Certified Internal Auditor (CIA) exam is developed and administered by the Institute of Internal Auditors (IIA). According to the IIA website, the four-part CIA exam tests "candidates' grasp of internal auditing's role in governance, risk, and control; conducting an audit engagement; business analysis and information technology; and business management skills."^[11]

If a candidate does not have a bachelor's degree, eligibility to take the CIA is based on a combination of work experience and education experience. In order to earn the CIA designation, a passing score of 80% is required. After successful passage of the CIA exam, certificate holders are required to earn eighty hours of continuing education credit every two years.^[12]

11 The Institute of Internal Auditors. "What Does It Take to Be a Professional?" n.d. https://na.theiia.org/about-ia/PublicDocuments/WDIT_Professional-WEB.pdf

12 The Institute of Internal Auditors. "What Does It Take to Be a Professional?" n.d. https://na.theiia.org/about-ia/PublicDocuments/WDIT_Professional-WEB.pdf

LINK TO LEARNING

Information about the Certified Internal Auditor (CIA) exam is provided by the following:

- [the Institute of Internal Auditors \(IIA\), Global \(https://openstax.org/l/50IIAGlobeCIA\)](https://openstax.org/l/50IIAGlobeCIA)
- [the Institute of Internal Auditors \(IIA\), North America \(https://openstax.org/l/50IIANorthAmCIA\)](https://openstax.org/l/50IIANorthAmCIA)

Certified Fraud Examiner (CFE)

The Certified Fraud Examiner (CFE) exam is developed and administered by the Association of Certified Fraud Examiners (ACFE). Eligibility to take the CFE is based on a points system based on education and work experience. Candidates with forty points may take the CFE exam, and official certification is earned with fifty points or more. A bachelor's degree, for example, is worth forty points toward eligibility of the fifty-point requirement for the CFE certification. The CFE offers an attractive supplement for students interested in pursuing a career in accounting fraud detection. Students might also consider studying forensic accounting in college. These courses are often offered at the graduate level.

The CFE exam has four parts: Fraud Prevention and Deterrence, Financial Transactions and Fraud Schemes, Investigation, and Law. Candidates must earn a minimum score of 75%. Once the CFE is earned, certificate holders must annually complete at least twenty hours of continuing education. The CFE certification is valued in many organizations, including governmental agencies at the local, state, and federal levels.

LINK TO LEARNING

Visit the Association of Certified Fraud Examiners (ACFE) page on the [Certified Fraud Examiner \(CFE\) exam \(https://openstax.org/l/50ACFE_CFEexam\)](https://openstax.org/l/50ACFE_CFEexam) to learn more.

Chartered Financial Analyst (CFA)

The Chartered Financial Analyst (CFA) certification is developed and administered by the CFA Institute. The CFA exam contains three levels (level I, level II, and level III), testing expertise in Investment Tools, Asset Classes, and Portfolio Management. Those with a bachelor's degree are eligible to take the CFA exam. In lieu of a bachelor's degree, work experience or a combination of work experience and education is considered satisfactory for eligibility to take the CFA exam. After taking the exam, candidates receive a "Pass" or "Did Not Pass" result. A passing score is determined by the CFA Institute once the examination has been administered. The passing score threshold is established after considering factors such as exam content and current best practices. After successful passage of all three levels of the CFA examination, chartered members must earn at least twenty hours annually of continuing education, of which two hours must be in Standards, Ethics, and Regulations (SER).

LINK TO LEARNING

Visit the the CFA Institute's page on the [Chartered Financial Analyst \(CFA\) exam \(https://openstax.org/l/50CFA_CFAexam\)](https://openstax.org/l/50CFA_CFAexam) to learn more.

Certified Financial Planner (CFP)

The Certified Financial Planner (CFP) certification is developed and administered by the Certified Financial Planner (CFP) Board of Standards. The CFP exam consists of 170 multiple-choice questions that are taken over two, three-hour sessions. There are several ways in which the eligibility requirements can be met in order to take the CFP exam, which students can explore using the CFP Board of Standards website. As with the Chartered Financial Analyst (CFA) exam, the CFP Board of Standards does not predetermine a passing score but establishes the pass/fail threshold through a deliberative evaluation process. Upon successful completion of the exam, CFPs must obtain thirty hours of continuing education every two years, with two of the hours focused on ethics.

LINK TO LEARNING

Visit the Certified Financial Planners (CFP) Board of Standards page on the [the Certified Financial Planner \(CFP\) exam \(https://openstax.org/l/50CFP_CFPexam\)](https://openstax.org/l/50CFP_CFPexam) to learn more.

Key Terms

accounting process of organizing, analyzing, and communicating financial information that is used for decision-making

auditing process of ensuring activities are carried out as intended or designed

consulting process of giving advice or guidance on financial and nonfinancial impact of a course of action

cost accounting recording and tracking of costs in the manufacturing process

creditor business that grants extended, but short-term, payment terms to other businesses

financial accounting measures the financial performance of an organization using standard conventions to prepare financial reports

Financial Accounting Standards Board (FASB) independent, nonprofit organization that sets financial accounting and reporting standards for both public and private sector businesses in the United States that use Generally Accepted Accounting Principles (GAAP)

for-profit business has the primary purpose of earning a profit by selling goods and services

generally accepted accounting principles (GAAP) common set of rules, standards, and procedures that publicly traded companies must follow when composing their financial statements

governmental accounting process of tracking the inflows and outflows of taxpayer funds using prescribed standards

Governmental Accounting Standards Board (GASB) source of generally accepted accounting principles (GAAP) used by state and local governments in the United States; is a private nongovernmental organization

governmental entity provides services to the general public (taxpayers)

lender bank or other institution that has the primary purpose of lending money

managerial accounting process that allows decision makers to set and evaluate business goals by determining what information they need to make a particular decision and how to analyze and communicate this information

manufacturing business for-profit business that is designed to make a specific product or products

nonprofit (not-for-profit) organization tax-exempt organization that serves its community in a variety of areas

not-for-profit (NFP) accounting including charities, universities, and foundations, helps ensure that donor funds are used for the intended mission of the not-for-profit entity

privately held company company whose stock is available only to employees or select individuals or groups

publicly traded company company whose stock is traded (bought and sold) on an organized stock exchange

retail business for-profit business that purchases products (called inventory) and resells the products without altering them

Securities and Exchange Commission (SEC) federal regulatory agency that regulates corporations with shares listed and traded on security exchanges through required periodic filings

service business business that does not sell tangible products to customers but rather sells intangible benefits (services) to customers; can be either a for-profit or a not-for-profit organization

stakeholder someone affected by decisions made by a company; may include an investor, creditor, employee, manager, regulator, customer, supplier, and layperson

stockholder owner of stock, or shares, in a business

transaction business activity or event that has an effect on financial information presented on financial statements



Summary

1.1 Explain the Importance of Accounting and Distinguish between Financial and Managerial Accounting

- Accounting is the process of organizing, analyzing, and communicating financial information that is used for decision-making.
- Accounting is often called the “language of business.”
- Financial accounting measures performance using financial reports and communicates results to those outside of the organization who may have an interest in the company’s performance, such as investors and creditors.
- Managerial accounting uses both financial and nonfinancial information to aid in decision-making.

1.2 Identify Users of Accounting Information and How They Apply Information

- The primary goal of accounting is to provide accurate, timely information to decision makers.
- Accountants provide information to internal and external users.
- Financial accounting measures an organization’s performance in monetary terms.
- Accountants use common conventions to prepare and convey financial information.
- Financial accounting is historical in nature, but a series of historical events can be useful in establishing predictions.
- Financial accounting is intended for use by both internal and external users.
- Managerial accounting is primarily intended for internal users.

1.3 Describe Typical Accounting Activities and the Role Accountants Play in Identifying, Recording, and Reporting Financial Activities

- Accountants play a vital role in many types of organizations.
- Organizations can be placed into three categories: for profit, governmental, and not for profit.
- For-profit organizations have a primary purpose of earning a profit.
- Governmental entities provide services to the general public, both individuals and organizations.
- Governmental agencies exist at the federal, state, and local levels.
- Not-for-profit entities have the primary purpose of serving a particular interest or need in communities.
- For-profit businesses can be further categorized into manufacturing, retail (or merchandising), and service.
- Manufacturing businesses are for-profit businesses that are designed to make a specific product or products.
- Retail firms purchase products and resell the products without altering the products.
- Service-oriented businesses provide services to customers.

1.4 Explain Why Accounting Is Important to Business Stakeholders

- Stakeholders are persons or groups that rely on financial information to make decisions.
- Stakeholders include stockholders, creditors, governmental and regulatory agencies, customers, and managers and other employees.
- Stockholders are owners of a business.
- Publicly traded companies sell stock (ownership) to the general public.
- Privately held companies offer stock to employees or to select individuals or groups outside the organization.
- Creditors sometimes grant extended payment terms to other businesses, normally for short periods of time, such as thirty to forty-five days.

- Lenders are banks and other institutions that have a primary purpose of lending money for long periods of time.
- Businesses generally have three ways to raise capital (money): profitable operations, selling ownership (called equity financing), and borrowing from lenders (called debt financing).
- In business, profit means the inflows of resources are greater than the outflows of resources.
- Publicly traded companies are required to file with the Securities and Exchange Commission (SEC), a federal government agency charged with protecting the investing public.
- Guidelines for the accounting profession are called accounting standards or generally accepted accounting principles (GAAP).
- The Securities and Exchange Commission (SEC) is responsible for establishing accounting standards for companies whose stocks are traded publicly on a national or regional stock exchange, such as the New York Stock Exchange (NYSE).
- Governmental and regulatory agencies at the federal, state, and local levels use financial information to accomplish the mission of protecting the public interest.
- Customers, employees, and the local community benefit when businesses are financially successful.

1.5 Describe the Varied Career Paths Open to Individuals with an Accounting Education

- It is important for accountants to be well versed in written and verbal communication and possess other nonaccounting skill sets.
- A bachelor's degree is typically required for entry-level work in the accounting profession.
- Advanced degrees and/or professional certifications are beneficial for advancement within the accounting profession.
- Career paths within the accounting profession include auditing, taxation, financial accounting, consulting, accounting information systems, cost and managerial accounting, financial planning, and entrepreneurship.
- Internal control systems help ensure the company's goals are being met and company assets are protected.
- Internal auditors work inside business and evaluate the effectiveness of internal control systems.
- Accountants help ensure the taxes are paid properly and in a timely manner.
- Accountants prepare financial statements that are used by decision makers inside and outside of the organization.
- Accountants can advise managers and other decision makers.
- Accountants are often an integral part of managing a company's computerized accounting and information system.
- Cost accounting determines the costs involved with providing goods and services.
- Managerial accounting incorporates financial and nonfinancial information to make decisions for a business.
- Training in accounting is helpful for financial planning services for businesses and individuals.
- Accounting helps entrepreneurs understand the financial implications of their business.
- Accountants have opportunities to work for many types of organizations, including public accounting firms, corporations, governmental entities, and not-for-profit entities.
- Professional certifications offer many benefits to those in the accounting and related professions.
- Common professional certifications include Certified Public Accountant (CPA), Certified Management Accountant (CMA), Certified Internal Auditor (CIA), Certified Fraud Examiner (CFE), Chartered Financial Analyst (CFA), and Certified Financial Planner (CFP).



Multiple Choice

1. **LO 1.2** Accounting is sometimes called the “language of ____.”
 - A. Wall Street
 - B. business
 - C. Main Street
 - D. financial statements
2. **LO 1.2** Financial accounting information _____.
 - A. should be incomplete in order to confuse competitors
 - B. should be prepared differently by each company
 - C. provides investors guarantees about the future
 - D. summarizes what has already occurred
3. **LO 1.2** External users of financial accounting information include all of the following *except* _____.
 - A. lenders such as bankers
 - B. governmental agencies such as the IRS
 - C. employees of a business
 - D. potential investors
4. **LO 1.2** Which of the following groups would have access to managerial accounting information?
 - A. bankers
 - B. investors
 - C. competitors of the business
 - D. managers
5. **LO 1.2** All of the following are examples of managerial accounting activities *except* _____.
 - A. preparing external financial statements in compliance with GAAP
 - B. deciding whether or not to use automation
 - C. making equipment repair or replacement decisions
 - D. deciding whether or not to use automation
6. **LO 1.3** Which of the following is *not* true?
 - A. Organizations share a common purpose or mission.
 - B. Organizations have inflows and outflows of resources.
 - C. Organizations add value to society.
 - D. Organizations need accounting information.
7. **LO 1.3** The primary purpose of what type of business is to serve a particular need in the community?
 - A. for-profit
 - B. not-for-profit
 - C. manufacturing
 - D. retail

8. **L0 1.3** Which of the following is *not* an example of a retailer?
- A. electronics store
 - B. grocery store
 - C. car dealership
 - D. computer manufacturer
 - E. jewelry store
9. **L0 1.3** A governmental agency can best be described by which of the following statements?
- A. has a primary purpose of making a profit
 - B. has a primary purpose of using taxpayer funds to provide services
 - C. produces goods for sale to the public
 - D. has regular shareholder meetings
10. **L0 1.3** Which of the following is likely *not* a type of not-for-profit entity?
- A. public library
 - B. community foundation
 - C. university
 - D. local movie theater
11. **L0 1.4** Which of the following is *not* considered a stakeholder of an organization?
- A. creditors
 - B. lenders
 - C. employees
 - D. community residents
 - E. a business in another industry
12. **L0 1.4** Stockholders can best be defined as which of the following?
- A. investors who lend money to a business for a short period of time
 - B. investors who lend money to a business for a long period of time
 - C. investors who purchase an ownership in the business
 - D. analysts who rate the financial performance of the business
13. **L0 1.4** Which of the following sell stock on an organized stock exchange such as the New York Stock Exchange?
- A. publicly traded companies
 - B. not-for-profit businesses
 - C. governmental agencies
 - D. privately held companies
 - E. government-sponsored entities
14. **L0 1.4** All of the following are sustainable methods businesses can use to raise capital (funding) *except* for _____.
- A. borrowing from lenders
 - B. selling ownership shares
 - C. profitable operations
 - D. tax refunds

15. **LO 1.4** The accounting information of a privately held company is generally available to all of the following *except for* _____.
A. governmental agencies
B. investors
C. creditors and lenders
D. competitors
16. **LO 1.5** Which of the following skills/attributes is *not* a primary skill for accountants to possess?
A. written communication
B. verbal communication
C. ability to work independently
D. analytical thinking
E. extensive computer programing background
17. **LO 1.5** Which of the following is typically required for entry-level positions in the accounting profession?
A. bachelor's degree
B. master's degree
C. Certified Public Accountant (CPA)
D. Certified Management Accountant (CMA)
E. only a high school diploma
18. **LO 1.5** Typical accounting tasks include all of the following tasks *except* _____.
A. auditing
B. recording and tracking costs
C. tax compliance and planning
D. consulting
E. purchasing direct materials
19. **LO 1.5** What type of organization primarily offers tax compliance, auditing, and consulting services?
A. corporations
B. public accounting firms
C. governmental entities
D. universities
20. **LO 1.5** Most states require 150 semester hours of college credit for which professional certification?
A. Certified Management Accountant (CMA)
B. Certified Internal Auditor (CIA)
C. Certified Public Accountant (CPA)
D. Certified Financial Planner (CFP)



Questions

1. **LO 1.2** Research your top five career choices. Identify financial factors that might influence your career choice. The following websites might be helpful in answering this question.
- Occupational Outlook Handbook: <https://www.bls.gov/ooh/>
 - National Association of Colleges and Employers: <http://www.nacweb.org/>
 - O*Net OnLine: <https://www.onetonline.org/find/>

2. **LO 1.2** Using the same top five career choices, identify nonfinancial factors that might influence your career choice. The following websites might be helpful in answering this question.

- Occupational Outlook Handbook: <https://www.bls.gov/ooh/>
- National Association of Colleges and Employers: <http://www.naceweb.org/>
- O*Net OnLine: <https://www.onetonline.org/find/>

3. **LO 1.2** Think about a recent purchase you made. Describe what financial and nonfinancial factors went into that purchase. Rank the factors, and explain how you made the final decision to purchase the item.

4. **LO 1.2** Computerized accounting systems help businesses efficiently record and utilize financial information. QuickBooks is a popular software package for small businesses. Explore the QuickBooks website at <https://quickbooks.intuit.com/>. Select one of the QuickBooks plans, and discuss some of the capabilities of the software. Taking the perspective of a small business owner, explain how this software might help the business.

5. **LO 1.2** The following information was taken from the **Netflix** financial statements.

NETFLIX, INC. Consolidated Statement of Operations For the Years 2014, 2015, and 2016			
	Dec. 31, 2014	Dec. 31, 2015	Dec. 31, 2016
Sales	\$5,504,656*	\$6,779,511	\$8,830,669
<i>*Dollar values are in thousands of US dollars.</i> Source: United States Security and Exchange Commission. "Netflix, Inc. Consolidated Statements of Operations." www.sec.gov			

For **Netflix**, sales is the product of the number of subscribers and the price charged for each subscription. What observations can you make about the previous three years of **Netflix**'s sales? Given this data, provide any predictions you can make about the future financial performance of **Netflix**. What nonfinancial factors influenced that prediction?

6. **LO 1.2** The following chart shows the price of **Netflix** stock for the six-month period from August 2017 to January 2018.



Source: Nasdaq. "Netflix, Inc. Stock Chart." www.nasdaq.com

Assume you are considering purchasing **Netflix** stock. What considerations would influence your decision? Relative to **Netflix**'s financial performance, what factors would influence the decision, and how would those factors rank in your decision? What about the nonfinancial factors?

7. **LO 1.3** Use the internet to research one for-profit, one governmental, and one not-for-profit entity. For each entity, describe the following:

- A. the primary purpose of the entity
- B. the types of activities that accountants would record (hint: what is the source of the entity's funding, and what costs might the entity have?)
- C. the types of decisions that might be made in this organization and how financial and nonfinancial information might help the decision-making process

8. **LO 1.3** Use the internet to research one manufacturing, one retail (or merchandising), and one service business. For each business, describe the following:

- A. the primary purpose of the entity
- B. the types of activities that accountants would record (hint: what is the source of the business' funding, and what costs might the business have?)
- C. the types of decisions that might be made in this organization and how financial and nonfinancial information might help the decision-making process

9. **LO 1.3** Assume you are considering opening a retail business. You are trying to decide whether to have a traditional "brick-and-mortar" store or to sell only online. Explain how the activities and costs differ between these two retail arrangements.

10. **LO 1.3** **Uber** and **Lyft** are two popular ride-sharing services. Imagine that you are visiting New York City for a family vacation. You are trying to decide whether to use one of these ride-sharing services to get around the city or rent a car and drive yourself. Considering the perspectives of the passengers (your family), the drivers, and the company (**Uber** or **Lyft**), explain the following:
- why ride-sharing services have gained in popularity
 - the financial considerations relevant to your decision
 - the nonfinancial considerations relevant to your decision
11. **LO 1.3** How would you categorize or classify a company like **Disney**?
12. **LO 1.3** **Charity Navigator** (<https://www.charitynavigator.org>) is a website dedicated to providing information regarding not-for-profit charitable organizations.
- After reviewing the website, explain how not-for-profit organizations are rated.
 - Explain why there is a need for the type of information provided by Charity Navigator.
 - Choose one to two charities listed in the website. Explain the information provided about the charity (financial and nonfinancial), the rating of the charity, and any other relevant factors.
13. **LO 1.4** Use the internet to visit the Securities and Exchange Commission (SEC) website (<https://www.sec.gov/>). Write a report discussing the following:
- several of the services provided by the SEC
 - why the services are important to the investing public
 - why you think the SEC would require publicly traded companies to file financial information
14. **LO 1.4** Imagine that you have just been elected president of your university's student senate. Assume the university is considering constructing a new student union—a place that offers a variety of stores, restaurants, and entertainment option for students—and has asked the student senate to develop a formal position in support or opposition of the new student union.
- Identify the stakeholders involved in this decision. Discuss the relevant considerations that each stakeholder might have.
 - Discuss the financial information that might be helpful in formulating the student senate position.
 - Discuss the nonfinancial information that might be helpful in formulating the student senate position.
15. **LO 1.4** According to a company press release, on January 5, 2012, **Hansen Natural Corporation** changed its name to **Monster Beverage Corporation**. According to Yahoo Finance, on that day the value of the company stock (symbol: MNST) was \$15.64 per share. On January 5, 2018, the stock closed at \$63.49 per share. This represents an increase of nearly 306%.
- Discuss the factors that might influence the increase in share price.
 - Consider yourself as a potential shareholder. What factors would you consider when deciding whether or not to purchase shares in **Monster Beverage Corporation** today?
16. **LO 1.4** The Dow Jones Industrial Average (DJIA) is often cited as a key metric for business activity. The average is a mathematical formula that uses the stock prices of thirty companies traded on the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ) system.
- Identify several of the companies that are included in the DJIA.
 - Explain why this metric might be commonly used to measure business activity.
 - Research the history of the DJIA and note some interesting facts. When did the Dow begin? What was the first value? What was the lowest value? The following is an example of a website that may be helpful: <http://www.dow-jones-djia.com/history-of-dow-jones-industrial-average-index/>.
 - What is the current value of the DJIA? What factors might contribute to the difference between early and current values of the DJIA?

17. **L0 1.5** Many professional certifications now have requirements for ethics training.

- A. Define ethics.
- B. Why does the accounting profession put so much emphasis on acting ethically?

18. **L0 1.5** The Certified Public Accountant (CPA) exam is a uniform exam that is administered by a national organization. Licenses, however, are issued by individual states.

- A. Explain why you think each state is responsible for issuing CPA licenses.
- B. Choose two to three states, and compare and contrast the requirements to become a CPA. Are they fairly consistent or drastically different from each other? A helpful resource is <https://www.thiswaytocpa.com/>. You may also find it helpful to search the board of accountancy for each state.
- C. Tax preparation is a large part of what many CPAs do. Students may be interested to know that a CPA (or any other licensing) is not required to prepare tax returns. Assume you know two friends who prepare tax returns for others, one is a CPA and one is not. Assume that both friends intend to move next year and will, therefore, prepare taxes in another state. Analyze this situation.

19. **L0 1.5** Accounting is not the only profession to offer professional certifications. Many other professions have certifications that are either required or encouraged for entry or advancement in the profession. Think of two to three career paths that you have considered or are considering. After doing some research, complete the following:

- A. Identify the name of the certification and the institute that administered the certification.
- B. Explain the education and/or experience requirements for taking the exam and earning the license.
- C. Discuss any of the benefits, financial or otherwise, of earning the certification.

20. **L0 1.5** Assume you are considering earning a master's degree (or even doctorate) after earning your bachelor's degree. One option is to continue directly into a master's program and then enter the workforce. Another option is to gain some work experience and then return to graduate school and earn your master's degree.

- A. Evaluate these options, and identify the advantages and disadvantages of each.
- B. It may be helpful to do some research on earnings and advancement potential, available formats of graduate programs (full time, part time, online), and other factors that might influence your decision. You may want to research graduate programs and utilize sites such as the Occupational Outlook Handbook (<https://www.bls.gov/ooh/>).

Introduction to Financial Statements

Figure 2.1 Derek's Venture. Technology can be a great tool for those who are far away from friends and family. Tablets are one way for those unfamiliar with technology to become comfortable using technology to connect with others. (credit: modification of "Lady Elderly" by "MabelAmber"/Pixabay, CC0)

Chapter Outline

- L0 2.1** Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate
- L0 2.2** Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses
- L0 2.3** Prepare an Income Statement, Statement of Owner's Equity, and Balance Sheet



Why It Matters

As a teenager, Derek loves computers. He also enjoys giving back to the community by helping others. Derek understands that many senior citizens live far away from their families, resulting in infrequent visits and loneliness. This summer he is considering combining both things he enjoys by working with the local retirement center. His idea is to have workshops to show the senior citizens how to connect with their families through the use of technology. The director of the retirement center is enthused about Derek's idea and has agreed to pay him for the services. During his visits, he will set up tablets and then show the seniors how to use them. Since he lives nearby, he will also provide support on an as-needed basis.

While he is excited about this opportunity, he is also trying to save up money for college. Although the retirement center will pay him for the workshops, he knows the investment in providing tablets will be expensive, and he wants to ensure he can cover his costs. A neighbor who works in banking suggests that Derek get a small loan to cover the costs of the tablets and use the income he earns to repay the loan. Derek is excited by the idea but is anxious when his neighbor mentions he will have to provide the bank monthly financial information, such as checking account and other financial statements. While he enjoys technology

and helping others, he is unfamiliar with financial statements. Derek decides to learn more about how financial statements will help both him and the bank make sound financial decisions.

2.1 Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate

The study of accounting requires an understanding of precise and sometimes complicated terminology, purposes, principles, concepts, and organizational and legal structures. Typically, your introductory accounting courses will familiarize you with the overall accounting environment, and for those of you who want greater detail, there is an assortment of more advanced accounting courses available.

This chapter concentrates on the four major types of financial statements and their interactions, the major types of business structures, and some of the major terms and concepts used in this course. Coverage here is somewhat basic since these topics are accorded much greater detail in future chapters.

Types of Business Structure

As you learned in [Role of Accounting in Society](#), virtually every activity that occurs in a business has an associated cost or value. Part of an accountant's role is to quantify these activities, or transactions.

Also, in business—and accounting in particular—it is necessary to distinguish the business entity from the individual owner(s). The personal transactions of the owners, employees, and other parties connected to the business should not be recorded in the organization's records; this accounting principle is called the *business entity concept*. Accountants should record only business transactions in business records.

This separation is also reflected in the legal structure of the business. There are several common types of legal business structures. While the accounting concepts for the various types of businesses are essentially the same regardless of the legal structure, the terminology will change slightly depending on the organization's legal structure, and it is important to understand the differences.

There are three broad categories for the legal structure of an organization: sole proprietorship, partnership, and corporation. A **sole proprietorship** is a legal business structure consisting of a single individual. Benefits of this type of structure include ease of formation, favorable tax treatment, and a high level of control over the business. The risks involved with sole proprietorships include unlimited personal liability and a limited life for the business. Unless the business is sold, the business ends when the owner retires or passes away. In addition, sole proprietorships have a fairly limited ability to raise capital (funding), and often sole proprietors have limited expertise—they are excellent at what they do but may have limited expertise in other important areas of business, such as accounting or marketing.

A **partnership** is a legal business structure consisting of an association of two or more people who contribute money, property, or services to operate as co-owners of a business. Benefits of this type of structure include favorable tax treatment, ease of formation of the business, and better access to capital and expertise. The downsides to a partnership include unlimited personal liability (although there are other legal structures—a limited liability partnership, for example—to help mitigate the risk); limited life of the partnership, similar to sole proprietorships; and increased complexity to form the venture (decision-making authority, profit-sharing arrangement, and other important issues need to be formally articulated in a written partnership agreement).

A **corporation** is a legal business structure involving one or more individuals (owners) who are legally distinct (separate) from the business. A primary benefit of a corporate legal structure is the owners of the organization

have limited liability. That is, a corporation is “stand alone,” conducting business as an entity separate from its owners. Under the corporate structure, owners delegate to others (called agents) the responsibility to make day-to-day decisions regarding the operations of the business. Other benefits of the corporate legal structure include relatively easy access to large amounts of capital by obtaining loans or selling ownership (stock), and since the stock is easily sold or transferred to others, the business operates beyond the life of the shareholders. A major disadvantage of a corporate legal structure is double taxation—the business pays income tax and the owners are taxed when distributions (also called dividends) are received.

Types of Business Structures

	Sole Proprietorship	Partnership	Corporation
Number of Owners	Single individual	Two or more individuals	One or more owners
Ease of Formation	Easier to form	Harder to form	Difficult to form
Ability to Raise Capital	Difficult to raise capital	Harder to raise capital	Easier to raise capital
Liability Risk	Unlimited liability	Unlimited liability	Limited liability
Taxation Consideration	Single taxation	Single taxation	Double taxation

Table 2.1

The Four Financial Statements

Are you a fan of books, movies, or sports? If so, chances are you have heard or said the phrase “spoiler alert.” It is used to forewarn readers, viewers, or fans that the ending of a movie or book or outcome of a game is about to be revealed. Some people prefer knowing the end and skipping all of the details in the middle, while others prefer to fully immerse themselves and then discover the outcome. People often do not know or understand what accountants produce or provide. That is, they are not familiar with the “ending” of the accounting process, but that is the best place to begin the study of accounting.

Accountants create what are known as financial statements. Financial statements are reports that communicate the financial performance and financial position of the organization.

In essence, the overall purpose of financial statements is to evaluate the performance of a company, governmental entity, or not-for-profit entity. This chapter illustrates this through a company, which is considered to be in business to generate a profit. Each financial statement we examine has a unique function, and together they provide information to determine whether a company generated a profit or loss for a given period (such as a month, quarter, or year); the assets, which are resources of the company, and accompanying liabilities, which are obligations of the company, that are used to generate the profit or loss; owner interest in profits or losses; and the cash position of the company at the end of the period.

The four financial statements that perform these functions and the order in which we prepare them are:

1. Income Statement
2. Statement of Owner’s Equity
3. Balance Sheet

4. Statement of Cash Flows.

The order of preparation is important as it relates to the concept of how financial statements are interrelated. Before explaining each in detail, let's explore the purpose of each financial statement and its main components.

CONTINUING APPLICATION AT WORK

Introduction to the Gearhead Outfitters Story

Gearhead Outfitters, founded by Ted Herget in 1997 in Jonesboro, Arkansas, is a retail chain that sells outdoor gear for men, women, and children. The company's inventory includes clothing, footwear for hiking and running, camping gear, backpacks, and accessories, by brands such as **The North Face**, **Birkenstock**, **Wolverine**, **Yeti**, **Altra**, **Mizuno**, and **Patagonia**. Herget fell in love with the outdoor lifestyle while working as a ski instructor in Colorado and wanted to bring that feeling back home to Arkansas. And so, **Gearhead** was born in a small downtown location in Jonesboro. The company has had great success over the years, expanding to numerous locations in Herget's home state, as well as Louisiana, Oklahoma, and Missouri.

While Herget knew his industry when starting **Gearhead**, like many entrepreneurs he faced regulatory and financial issues that were new to him. Several of these issues were related to accounting and the wealth of decision-making information that accounting systems provide.

For example, measuring revenue and expenses, providing information about cash flow to potential lenders, analyzing whether profit and positive cash flow is sustainable to allow for expansion, and managing inventory levels. Accounting, or the preparation of financial statements (balance sheet, income statement, and statement of cash flows), provides the mechanism for business owners such as Herget to make fundamentally sound business decisions.

Purpose of Financial Statements

Before exploring the specific financial statements, it is important to know why these are important documents. To understand this, you must first understand who the users of financial statements are. Users of the information found in financial statements are called stakeholders. A **stakeholder** is someone affected by decisions made by a company; this can include groups or individuals affected by the actions or policies of an organization, including include investors, creditors, employees, managers, regulators, customers, and suppliers. The stakeholder's interest sometimes is not directly related to the entity's financial performance. Examples of stakeholders include lenders, investors/owners, vendors, employees and management, governmental agencies, and the communities in which the businesses operate. Stakeholders are interested in the performance of an organization for various reasons, but the common goal of using the financial statements is to understand the information each contains that is useful for making financial decisions. For example, a banker may be interested in the financial statements to decide whether or not to lend the organization money.

Likewise, small business owners may make decisions based on their familiarity with the business—they know if the business is doing well or not based on their "gut feeling." By preparing the financial statements,

accountants can help owners by providing clarity of the organization's financial performance. It is important to understand that, in the long term, every activity of the business has a financial impact, and financial statements are a way that accountants report the activities of the business. Stakeholders must make many decisions, and the financial statements provide information that is helpful in the decision-making process.

As described in [Role of Accounting in Society](#), the complete set of financial statements acts as an X-ray of a company's financial health. By evaluating all of the financial statements together, someone with financial knowledge can determine the overall health of a company. The accountant can use this information to advise outside (and inside) stakeholders on decisions, and management can use this information as one tool to make strategic short- and long-term decisions.

ETHICAL CONSIDERATIONS

Utilitarian View of Accounting Decisions and Stakeholder Well-Being

Utilitarianism is a well-known and influential moral theory commonly used as a framework to evaluate business decisions. Utilitarianism suggests that an ethical action is one whose consequence achieves the greatest good for the greatest number of people. So, if we want to make an ethical decision, we should ask ourselves who is helped and who is harmed by it. Focusing on consequences in this way generally does not require us to take into account the means of achieving that particular end, however. Put simply, the utilitarian view is an ethical theory that the best action of a company is the one that maximizes utility of all stakeholders to the decision. This view assumes that all individuals with an interest in the business are considered within the decision.

Financial statements are used to understand the financial performance of companies and to make long- and short-term decisions. A utilitarian approach considers all stakeholders, and both the long- and short-term effects of a business decision. This allows corporate decision makers to choose business actions with the potential to produce the best outcomes for the majority of all stakeholders, not just shareholders, and therefore maximize stakeholder happiness.

Accounting decisions can change the approach a stakeholder has in relation to a business. If a company focuses on modifying operations and financial reporting to maximize short-term shareholder value, this could indicate the prioritization of certain stakeholder interests above others. When a company pursues only short-term profit for shareholders, it neglects the well-being of other stakeholders. Professional accountants should be aware of the interdependent relationship between all stakeholders and consider whether the results of their decisions are good for the majority of stakeholder interests.

YOUR TURN

Business Owners as Decision Makers

Think of a business owner in your family or community. Schedule some time to talk with the business owner, and find out how he or she uses financial information to make decisions.

Solution

Business owners will use financial information for many decisions, such as comparing sales from one period to another, determining trends in costs and other expenses, and identifying areas in which to reduce or reallocate expenses. This information will be used to determine, for example, staffing and inventory levels, streamlining of operations, and advertising or other investment decisions.

The Income Statement

The first financial statement prepared is the **income statement**, a statement that shows the organization's financial performance *for a given period of time*. Let's illustrate the purpose of an income statement using a real-life example. Assume your friend, Chris, who is a sole proprietor, started a summer landscaping business on August 1, 2020. It is categorized as a service entity. To keep this example simple, assume that she is using her family's tractor, and we are using the *cash basis* method of accounting to demonstrate Chris's initial operations for her business. The other available basis method that is commonly used in accounting is the *accrual basis* method. She is responsible for paying for fuel and any maintenance costs. She named the business Chris' Landscaping. On August 31, Chris checked the account balance and noticed there is only \$250 in the checking account. This balance is lower than expected because she thought she had been paid by some customers. Chris decides to do some research to determine why the balance in the checking account is lower than expected. Her research shows that she earned a total of \$1,400 from her customers but had to pay \$100 to fix the brakes on her tractor, \$50 for fuel, and also made a \$1,000 payment to the insurance company for business insurance. The reason for the lower-than-expected balance was due to the fact that she spent (\$1,150 for brakes, fuel, and insurance) only slightly less than she earned (\$1,400)—a net increase of \$250. While she would like the checking balance to grow each month, she realizes most of the August expenses were infrequent (brakes and insurance) and the insurance, in particular, was an unusually large expense. She is convinced the checking account balance will likely grow more in September because she will earn money from some new customers; she also anticipates having fewer expenses.

CHRIS' LANDSCAPING Income Statement For the Month Ended August 31, 2020		
Revenue	\$1,400	
Total revenue		\$1,400
Expenses		
Tractor brake repair	100	
Tractor fuel	50	
Business insurance	<u>1,000</u>	
Total expenses		<u>1,150</u>
Net income		<u>\$ 250</u>

The Income Statement can also be visualized by the formula: Revenue – Expenses = Net Income/(Loss).

Let's change this example slightly and assume the \$1,000 payment to the insurance company will be paid in September, rather than in August. In this case, the ending balance in Chris's checking account would be \$1,250, a result of earning \$1,400 and only spending \$100 for the brakes on her car and \$50 for fuel. This stream of cash flows is an example of cash basis accounting because it reflects when payments are received

and made, not necessarily the time period that they affect. At the end of this section and in [The Adjustment Process](#) you will address accrual accounting, which does reflect the time period that they affect.

In accounting, this example illustrates an income statement, a financial statement that is used to measure the financial performance of an organization for a particular period of time. We use the simple landscaping account example to discuss the elements of the income statement, which are revenues, expenses, gains, and losses. Together, these determine whether the organization has net income (where revenues and gains are greater than expenses and losses) or net loss (where expenses and losses are greater than revenues and gains). Revenues, expenses, gains, and losses are further defined here.

Revenue

Revenue^[1] is the value of goods and services the organization sold or provided to customers for a given period of time. In our current example, Chris's landscaping business, the "revenue" earned for the month of August would be \$1,400. It is the value Chris received in exchange for the services provided to her clients. Likewise, when a business provides goods or services to customers for cash at the time of the service or in the future, the business classifies the amount(s) as revenue. Just as the \$1,400 earned from a business made Chris's checking account balance increase, revenues increase the value of a business. In accounting, revenues are often also called sales or fees earned. Just as earning wages from a business or summer job reflects the number of hours worked for a given rate of pay or payments from clients for services rendered, revenues (and the other terms) are used to indicate the dollar value of goods and services provided to customers for a given period of time.

YOUR TURN

Coffee Shop Products

Think about the coffee shop in your area. Identify items the coffee shop sells that would be classified as revenues. Remember, revenues for the coffee shop are related to its primary purpose: selling coffee and related items. Or, better yet, make a trip to the local coffee shop and get a first-hand experience.

Solution

Many coffee shops earn revenue through multiple revenue streams, including coffee and other specialty drinks, food items, gift cards, and merchandise.

Expenses

An **expense**^[2] is a cost associated with providing goods or services to customers. In our opening example, the expenses that Chris incurred totaled \$1,150 (consisting of \$100 for brakes, \$50 for fuel, and \$1,000 for

1 In a subsequent section of this chapter, you will learn that the accounting profession is governed by the Financial Accounting Standards Board (or FASB), a professional body that issues guidelines/pronouncements for the accounting profession. A set of theoretical pronouncements issued by FASB is called Statement of Financial Accounting Concepts (SFAC). In SFAC No. 6, FASB defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations" (SFAC No. 6, p. 23).

2 Expenses are formally defined by the FASB as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" (SFAC No. 6, p. 23).

insurance). You might think of expenses as the opposite of revenue in that expenses reduce Chris's checking account balance. Likewise, expenses decrease the value of the business and represent the dollar value of costs incurred to provide goods and services to customers for a given period of time.

YOUR TURN

Coffee Shop Expenses

While thinking about or visiting the coffee shop in your area, look around (or visualize) and identify items or activities that are the expenses of the coffee shop. Remember, expenses for the coffee shop are related to resources consumed while generating revenue from selling coffee and related items. Do not forget about any expenses that might not be so obvious—as a general rule, every activity in a business has an associated cost.

Solution

Costs of the coffee shop that might be readily observed would include rent; wages for the employees; and the cost of the coffee, pastries, and other items/merchandise that may be sold. In addition, costs such as utilities, equipment, and cleaning or other supplies might also be readily observable. More obscure costs of the coffee shop would include insurance, regulatory costs such as health department licensing, point-of-sale/credit card costs, advertising, donations, and payroll costs such as workers' compensation, unemployment, and so on.

Gains

A **gain**^[3] can result from selling ancillary business items for more than the items are worth. (Ancillary business items are those that are used to support business operations.) To illustrate the concept of a gain, let's return to our example. However, this example and the accompanying *losses* example are not going to be part of our income statement, balance sheet, or owner's equity statement discussions. The gains and losses examples are only to be used in demonstrating the concepts of gains and losses. Assume that Chris paid \$1,500 for a small piece of property to use for building a storage facility for her company. Further assume that Chris has an opportunity to sell the land for \$2,000. She subsequently found a better storage option and decided to sell the property. After doing so, Chris will have a gain of \$500 (a selling price of \$2,000 and a cost of \$1,500) and will also have \$2,000 to deposit into her checking account, which would increase the balance.

Thinking back to the proceeds (\$1,400) Chris received from her landscaping business, we might ask the question: how are gains similar to and different from revenues? The revenue of \$1,400 that Chris earned from her business and the \$2,000 she received from selling the land are similar in that both increase her checking account balance and make her business more valuable.

A difference, however, is evident if we consider how these funds were earned. Chris earned the \$1,400 because she provided services (her labor) to her clients. Chris's primary objective is to earn revenue by working for her clients. In addition, earning money by selling her land was an infrequent event for Chris, since her primary job was serving as a landscaper. Her primary goal is to earn fees or revenue, not to earn money by selling land. In

3 FASB notes that gains represent an increase in organizational value from activities that are "incidental or peripheral" (SFAC No. 6, p. 24) to the primary purpose of the business.

fact, she cannot consider doing that again because she does not have additional land to sell.

The primary goal of a business is to earn revenue by providing goods and services to customers in exchange for cash at that time or in the future. While selling other items for more than the value of the item does occur in business, these transactions are classified as gains, because these sales are infrequent and not the primary purpose of the business.

Losses

A **loss**^[4] results from selling ancillary business items for less than the items are worth. To illustrate, let's now assume that Chris sells her land that she purchased for \$1,500 at a sales price of \$1,200. In this case she would realize (incur) a loss of \$300 on the sale of the property (\$1,200 sales price minus the \$1,500 cost of purchasing the property) and will also have \$1,200 to deposit into her checking account, which would increase the balance.

You should not be confused by the fact that the checking account balance increased even though this transaction resulted in a financial loss. Chris received \$1,200 that she can deposit into her checking account and use for future expenses. The \$300 loss simply indicates that she received less for the land than she paid for it. These are two aspects of the same transaction that communicate different things, and it is important to understand the differences.

As we saw when comparing gains and revenues, losses are similar to expenses in that both losses and expenses decrease the value of the organization. In addition, just as Chris's primary goal is to earn money from her job rather than selling land, in business, losses refer to infrequent transactions involving ancillary items of the business.

Net Income (Net Loss)

Net income (net loss) is determined by comparing revenues and expenses. **Net income** is a result of revenues (inflows) being greater than expenses (outflows). A **net loss** occurs when expenses (outflows) are greater than revenues (inflows). In accounting it is common to present net income in the following format:

Net Income
Revenue (sometimes called Sales or Fees Earned)
<u>– Expenses</u>
Operating Profit (or Net Loss)

Recall that revenue is the value of goods and services a business provides to its customers and increase the value of the business. Expenses, on the other hand, are the costs of providing the goods and services and decrease the value of the business. When revenues exceed expenses, companies have net income. This means the business has been successful at earning revenues, containing expenses, or a combination of both. If, on the other hand, expenses exceed revenues, companies experience a net loss. This means the business was unsuccessful in earning adequate revenues, sufficiently containing expenses, or a combination of both. While businesses work hard to avoid net loss situations, it is not uncommon for a company to sustain a net loss from time-to-time. It is difficult, however, for businesses to remain viable while experiencing net losses over the long term.

Shown as a formula, the net income (loss) function is:

4 FASB notes losses represent a decrease in organizational value from activities that are "incidental or peripheral" (SFAC No. 6, p. 24) to the primary purpose of the business.

$$\begin{aligned} \text{Revenues (R)} - \text{Expenses (E)} &= \text{Net Income (when } R > E) \\ \text{Revenues (R)} - \text{Expenses (E)} &= \text{Net Loss (when } E > R) \end{aligned}$$

To be complete, we must also consider the impact of gains and losses. While gains and losses are infrequent in a business, it is not uncommon that a business would present a gain and/or loss in its financial statements. Recall that gains are similar to revenue and losses are similar to expenses. Therefore, the traditional accounting format would be:

Gains and Losses	
Revenue (sometimes called Sales or Fees Earned)	
+ Gains	
– Expenses	
– Losses	
Net Income (or Net Loss)	

Shown as a formula, the net income (loss) function, including gains and losses, is:

$$\begin{aligned} \text{Revenues (R)} + \text{Gains (G)} - \text{Expenses (E)} - \text{Losses (L)} &= \text{Net Income [when } (R + G) > (E + L)] \\ \text{Revenues (R)} + \text{Gains (G)} - \text{Expenses (E)} - \text{Losses (L)} &= \text{Net Loss [when } (E + L) > (R + G)] \end{aligned}$$

When assessing a company's net income, it is important to understand the source of the net income. Businesses strive to attain "high-quality" net income (earnings). High-quality earnings are based on sustainable earnings—also called permanent earnings—while relying less on infrequent earnings—also called temporary earnings. Recall that revenues represent the *ongoing* value of goods and services the business provides (sells) to its customers, while gains are *infrequent* and involve items ancillary to the primary purpose of the business. We should use caution if a business attains a significant portion of its net income as a result of gains, rather than revenues. Likewise, net losses derived as a result of losses should be put into the proper perspective due to the infrequent nature of losses. While net losses are undesirable for any reason, net losses that result from expenses related to ongoing operations, rather than losses that are infrequent, are more concerning for the business.

Statement of Owner's Equity

Equity is a term that is often confusing but is a concept with which you are probably already familiar. In short, equity is the value of an item that remains after considering what is owed for that item. The following example may help illustrate the concept of equity.

When thinking about the concept of equity, it is often helpful to think about an example many families are familiar with: purchasing a home. Suppose a family purchases a home worth \$200,000. After making a down payment of \$25,000, they secure a bank loan to pay the remaining \$175,000. What is the value of the family's equity in the home? If you answered \$25,000, you are correct. At the time of the purchase, the family owns a home worth \$200,000 (an asset), but they owe \$175,000 (a liability), so the equity or net worth in the home is \$25,000.

The **statement of owner's equity**, which is the second financial statement created by accountants, is a statement that shows how the equity (or value) of the organization has changed over time. Similar to the income statement, the statement of owner's equity is *for a specific period of time, typically one year*. Recall that another way to think about equity is net worth, or value. So, the statement of owner's equity is a financial

statement that shows how the net worth, or value, of the business has changed for a given period of time.

CHRIS' LANDSCAPING Statement of Owner's Equity For the Month Ended August 31, 2020	
Owner's equity, August 1	\$ 0
+ Net income	250
	<u>250</u>
Owner's equity, August 31	<u>\$250</u>

The elements of the financial statements shown on the statement of owner's equity include *investments by owners* as well as *distributions to owners*. Investments by owners and distributions to owners are two activities that impact the value of the organization (increase and decrease, respectively). In addition, net income or net loss affects the value of the organization (net income increases the value of the organization, and net loss decreases it). Net income (or net loss) is also shown on the statement of owner's equity; this is an example of how the statements are interrelated. Note that the word *owner's* (singular for a sole owner) changes to *owners'* (plural, for a group of owners) when preparing this statement for an entity with multiple owners versus a sole proprietorship.

In our example, to make it less complicated, we started with the first month of operations for Chris's Landscaping. In the first month of operations, the owner's equity total begins the month of August 2020, at \$0, since there have been no transactions. During the month, the business received revenue of \$1,400 and incurred expenses of \$1,150, for net income of \$250. Since Chris did not contribute any investment or make any withdrawals, other than the \$1,150 for expenses, the ending balance in the owner's equity account on August 31, 2020, would be \$250, the net income earned.

At this stage, it's important to point out that we are working with a sole proprietorship to help simplify the examples. We have addressed the owner's value in the firm as *capital* or *owner's equity*. However, later we switch the structure of the business to a corporation, and instead of owner's equity we begin using stockholder's equity, which includes account titles such as *common stock* and *retained earnings* to represent the owners' interests.

The corporate treatment is more complicated because corporations may have a few owners up to potentially thousands of owners (stockholders). More detail on this issue is provided in [Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses](#).

Investments by Owners

Generally, there are two ways by which organizations become more valuable: profitable operations (when revenues exceed expenses) and investments by owners. Organizations often have long-term goals or projects that are very expensive (for example, building a new manufacturing facility or purchasing another company).

While having profitable operations is a viable way to "fund" these goals and projects, organizations often want to undertake these projects in a quicker time frame. Selling ownership is one way to quickly obtain the funding necessary for these goals. **Investments by owners** represent an exchange of cash or other assets for which the investor is given an ownership interest in the organization. This is a mutually beneficial arrangement: the organization gets the funding it needs on a timely basis, and the investor gets an ownership interest in the organization.

When organizations generate funding by selling ownership, the ownership interest usually takes the form of **common stock**, which is the corporation's primary class of stock issued, with each share representing a partial claim to ownership or a share of the company's business. When the organization issues common stock for the first time, it is called an **initial public offering (IPO)**. In [Corporation Accounting](#), you learn more about the specifics of this type of accounting. Once a company issues (or sells) common stock after an IPO, we describe the company as a **publicly traded company**, which simply means the company's stock can be purchased by the general public on a public exchange like the New York Stock Exchange (NYSE). That is, investors can become owners of the particular company. Companies that issue publicly traded common shares in the United States are regulated by the **Securities and Exchange Commission (SEC)**, a federal regulatory agency that, among other responsibilities, is charged with oversight of financial investments such as common stock.

CONCEPTS IN PRACTICE

Roku Goes Public

On September 1, 2017, **Roku, Inc.** filed a Form S-1 with the Securities and Exchange Commission (SEC).^[5] In this form, **Roku** disclosed its intention to become a publicly traded company, meaning its stock will trade (sell) on public stock exchanges, allowing individual and institutional investors an opportunity to own a portion (shares) of the company. The Form S-1 included detailed financial and nonfinancial information about the company. The information from **Roku** also included the purpose of the offering as well as the intended uses of the funds. Here is a portion of the disclosure: "The principal purposes of this offering are to increase our capitalization and financial flexibility and create a public market for our Class A common stock. We intend to use the net proceeds we receive from this offering primarily for general corporate purposes, including working capital . . . research and development, business development, sales and marketing activities and capital expenditures."^[6]

On September 28, 2017, **Roku** "went public" and exceeded expectations. Prior to the IPO, **Roku** estimated it would sell between \$12 and \$14 per share, raising over \$117 million for the company. The closing price per share on September 28 was \$23.50, nearly doubling initial expectations for the share value.^[7]

Distributions to Owners

There are basically two ways in which organizations become less valuable in terms of owners' equity: from unprofitable operations (when expenses or losses exceed revenues or gains) and by distributions to owners. Owners (investors) of an organization want to see their investment appreciate (gain) in value. Over time, owners of common stock can see the value of the stock increase in value—the share price increases—due to the success of the organization. Organizations may also make **distributions to owners**, which are periodic rewards issued to the owners in the form of cash or other assets. Distributions to owners represent some of the value (equity) of the organization.

5 Roku, Inc. "Form S-1 Filing with the Securities and Exchange Commission." September 1, 2017. <https://www.sec.gov/Archives/edgar/data/1428439/000119312517275689/d403225ds1.htm>

6 Roku, Inc. "Form S-1 Filing with the Securities and Exchange Commission." September 1, 2017. <https://www.sec.gov/Archives/edgar/data/1428439/000119312517275689/d403225ds1.htm>

7 Roku, Inc. Data. <https://finance.yahoo.com/quote/ROKU/history?p=ROKU>

For investors who hold common stock in the organization, these periodic payments or distributions to owners are called **dividends**. For sole proprietorships, distributions to owners are withdrawals or drawings. From the organization's perspective, dividends represent a portion of the net worth (equity) of the organization that is returned to owners as a reward for their investment. While issuing dividends does, in fact, reduce the organization's assets, some argue that paying dividends increases the organization's long-term value by making the stock more desirable. (Note that this topic falls under the category of "dividend policy" and there is a significant stream of research addressing this.)

Balance Sheet

Once the statement of owner's equity is completed, accountants typically complete the **balance sheet**, a statement that lists what the organization owns (*assets*), what it owes (*liabilities*), and what it is worth (*equity*) on a *specific date*. Notice the change in timing of the report. The income statement and statement of owner's equity report the financial performance and equity change for a period of time. The balance sheet, however, lists the financial position at the close of business on a specific date. (Refer to [Figure 2.2](#) for the balance sheet as of August 31, 2020, for Chris' Landscaping.)

CHRIS' LANDSCAPING Balance Sheet August 31, 2020	
Assets	
Cash	\$250
Liabilities	
None	0
Owner's Equity	
Owner's Equity	\$250

Figure 2.2 "Balance Sheet for Chris' Landscaping." (attribution: Copyright, Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Assets

If you recall our previous example involving Chris and her newly established landscaping business, you are probably already familiar with the term **asset**^[8]—these are resources used to generate revenue. In Chris's business, to keep the example relatively simple, the business ended the month with one asset, cash, assuming that the insurance was for one month's coverage.

However, as organizations become more complex, they often have dozens or more types of assets. An asset can be categorized as a **short-term asset** or current asset (which is typically used up, sold, or converted to cash in one year or less) or as a **long-term asset** or noncurrent asset (which is not expected to be converted into cash or used up within one year). Long-term assets are often used in the production of products and services.

Examples of short-term assets that businesses own include cash, accounts receivable, and inventory, while examples of long-term assets include land, machinery, office furniture, buildings, and vehicles. Several of the chapters that you will study are dedicated to an in-depth coverage of the special characteristics of selected

⁸ The FASB defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (SFAC No. 6, p. 12).

assets. Examples include [Merchandising Transactions](#), which are typically short term, and [Long-Term Assets](#), which are typically long term.

An asset can also be categorized as a tangible asset or an intangible asset. **Tangible assets** have a physical nature, such as trucks or many inventory items, while **intangible assets** have value but often lack a physical existence or corpus, such as insurance policies or trademarks.

Liabilities

You are also probably already familiar with the term **liability**^[9]—these are amounts owed to others (called creditors). A liability can also be categorized as a **short-term liability** (or current liability) or a **long-term liability** (or noncurrent liability), similar to the treatment accorded assets. Short-term liabilities are typically expected to be paid within one year or less, while long-term liabilities are typically expected to be due for payment more than one year past the current balance sheet date.

Common short-term liabilities or amounts owed by businesses include amounts owed for items purchased on credit (also called *accounts payable*), taxes, wages, and other business costs that will be paid in the future. Long-term liabilities can include such liabilities as long-term notes payable, mortgages payable, or bonds payable.

Equity

In the Statement of Owner's Equity discussion, you learned that **equity** (or net assets) refers to book value or net worth. In our example, Chris's Landscaping, we determined that Chris had \$250 worth of equity in her company at the end of the first month (see [Figure 2.2](#)).

At any point in time it is important for stakeholders to know the financial position of a business. Stated differently, it is important for employees, managers, and other interested parties to understand what a business owns, owes, and is worth at any given point. This provides stakeholders with valuable financial information to make decisions related to the business.

Statement of Cash Flows

The fourth and final financial statement prepared is the **statement of cash flows**, which is a statement that lists the cash inflows and cash outflows for the business *for a period of time*. At first glance, this may seem like a redundant financial statement. We know the income statement also reports the inflows and outflows for the business for a period of time. In addition, the statement of owner's equity and the balance sheet help to show the other activities, such as investments by and distributions to owners that are not included in the income statement. To understand why the statement of cash flows is necessary, we must first understand the two bases of accounting used to prepare the financial statements. The changes in cash within this statement are often referred to as sources and uses of cash. A source of cash lets one see where cash is coming from. For example, is cash being generated from sales to customers, or is the cash a result of an advance in a large loan. Use of cash looks at what cash is being used for. Is cash being used to make an interest payment on a loan, or is cash being used to purchase a large piece of machinery that will expand business capacity? The two bases of accounting are the cash basis and the accrual basis, briefly introduced in [Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate](#).

9 The FASB defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (SFAC No. 6, p. 13).

Under **cash basis accounting**, transactions (i.e., a sale or a purchase) are not recorded in the financial statements until there is an exchange of cash. This type of accounting is permitted for nonprofit entities and small businesses that elect to use this type of accounting. Under **accrual basis accounting**, transactions are generally recorded in the financial statement when the transactions occur, and not when paid, although in some situations the two events could happen on the same day.

An example of the two methods (cash versus accrual accounting) would probably help clarify their differences. Assume that a mechanic performs a tune-up on a client's car on May 29, and the customer picks up her car and pays the mechanic \$100 on June 2. If the mechanic were using the cash method, the revenue would be recognized on June 2, the date of payment, and any expenses would be recognized when paid.

If the accrual method were used, the mechanic would recognize the revenue and any related expenses on May 29, the day the work was completed. The accrual method will be the basis for your studies here (except for our coverage of the cash flow statement in [Statement of Cash Flows](#)). The accrual method is also discussed in greater detail in [Explain the Steps within the Accounting Cycle through the Unadjusted Trial Balance](#).

While the cash basis of accounting is suited well and is more efficient for small businesses and certain types of businesses, such as farming, and those without inventory, like lawyers and doctors, the accrual basis of accounting is theoretically preferable to the cash basis of accounting. Accrual accounting is advantageous because it distinguishes between the timing of the transactions (when goods and services are provided) and when the cash involved in the transactions is exchanged (which can be a significant amount of time after the initial transaction). This allows accountants to provide, in a timely manner, relevant and complete information to stakeholders. [The Adjustment Process](#) explores several common techniques involved in accrual accounting.

Two brief examples may help illustrate the difference between cash accounting and accrual accounting.

Assume that a business sells \$200 worth of merchandise. In some businesses, there are two ways the customers pay: cash and credit (also referred to as "on account"). Cash sales include checks and credit cards and are paid at the time of the sale. Credit sales (not to be confused with credit card sales) allow the customer to take the merchandise but pay within a specified period of time, usually up to forty-five days.

A cash sale would be recorded in the financial statements under *both* the cash basis and accrual basis of accounting. It makes sense because the customer received the merchandise and paid the business at the same time. It is considered two events that occur simultaneously (exchange of merchandise for cash).

Similar to the previous example for the mechanic, a credit sale, however, would be treated differently under each of these types of accounting. Under the cash basis of accounting, a credit sale would not be recorded in the financial statements until the cash is received, under terms stipulated by the seller. For example, assume on April 1 a landscaping business provides \$500 worth of services to one of its customers. The sale is made on account, with the payment due forty-five days later. Under the cash basis of accounting, the revenue would not be recorded until May 16, when the cash was received. Under the accrual basis of accounting, this sale would be recorded in the financial statements at the time the services were provided, April 1. The reason the sale would be recorded is, under accrual accounting, the business reports that it provided \$500 worth of services to its customer. The fact the customers will pay later is viewed as a separate transaction under accrual accounting ([Figure 2.3](#)).

Cash ←	LANDSCAPE Statement of Cash Flows For Month Ended May 31, 2021	LANDSCAPE Statement of Cash Flows For Month Ended April 30, 2021	→ Accrual
	Cash Flow from Operations Net Earnings	Cash Flow from Operations Net Earnings	
	\$500	\$500	

Figure 2.3 Credit versus Cash. On the left is a credit sale recorded under the cash basis of accounting. On the right the same credit sale is recorded under the accrual basis of accounting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Let's now explore the difference between the cash basis and accrual basis of accounting using an expense. Assume a business purchases \$160 worth of printing supplies from a supplier (vendor). Similar to a sale, a purchase of merchandise can be paid for at the time of sale using cash (also a check or credit card) or at a later date (on account). A purchase paid with cash at the time of the sale would be recorded in the financial statements under *both* cash basis and accrual basis of accounting. It makes sense because the business received the printing supplies from the supplier and paid the supplier at the same time. It is considered two events that occur simultaneously (exchange of merchandise for cash).

If the purchase was made on account (also called a *credit purchase*), however, the transaction would be recorded differently under each of these types of accounting. Under the cash basis of accounting, the \$160 purchase on account would not be recorded in the financial statements until the cash is paid, as stipulated by the seller's terms. For example, if the printing supplies were received on July 17 and the payment terms were fifteen days, no transaction would be recorded until August 1, when the goods were paid for. Under the accrual basis of accounting, this purchase would be recorded in the financial statements at the time the business received the printing supplies from the supplier (July 17). The reason the purchase would be recorded is that the business reports that it bought \$160 worth of printing supplies from its vendors. The fact the business will pay later is viewed as a separate issue under accrual accounting. [Table 2.2](#) summarizes these examples under the different bases of accounting.

Transactions by Cash Basis versus Accrual Basis of Accounting

Transaction	Under Cash Basis Accounting	Under Accrual Basis Accounting
\$200 sale for cash	Recorded in financial statements at time of sale	Recorded in financial statements at time of sale
\$200 sale on account	<i>Not</i> recorded in financial statements until cash is received	Recorded in financial statements at time of sale
\$160 purchase for cash	Recorded in financial statements at time of purchase	Recorded in financial statements at time of purchase

Table 2.2 Businesses often sell items for cash as well as on account, where payment terms are extended for a period of time (for example, thirty to forty-five days). Likewise, businesses often purchase items from suppliers (also called vendors) for cash or, more likely, on account. Under the cash basis of accounting, these transactions would not be recorded until the cash is exchanged. In contrast, under accrual accounting the transactions are recorded when the transaction occurs, regardless of when the cash is received or paid.

Transactions by Cash Basis versus Accrual Basis of Accounting

Transaction	Under Cash Basis Accounting	Under Accrual Basis Accounting
\$160 purchase on account	<i>Not</i> recorded in financial statements until cash is paid	Recorded in financial statements at time of purchase

Table 2.2 Businesses often sell items for cash as well as on account, where payment terms are extended for a period of time (for example, thirty to forty-five days). Likewise, businesses often purchase items from suppliers (also called vendors) for cash or, more likely, on account. Under the cash basis of accounting, these transactions would not be recorded until the cash is exchanged. In contrast, under accrual accounting the transactions are recorded when the transaction occurs, regardless of when the cash is received or paid.

Knowing the difference between the cash basis and accrual basis of accounting is necessary to understand the need for the statement of cash flows. Stakeholders need to know the financial *performance* (as measured by the income statement—that is, net income or net loss) and financial *position* (as measured by the balance sheet—that is, assets, liabilities, and owners' equity) of the business. This information is provided in the income statement, statement of owner's equity, and balance sheet. However, since these financial statements are prepared using accrual accounting, stakeholders do not have a clear picture of the business's cash activities. The statement of cash flows solves this inadequacy by specifically focusing on the cash inflows and cash outflows.

2.2 Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses

In addition to what you've already learned about assets and liabilities, and their potential categories, there are a couple of other points to understand about assets. Plus, given the importance of these concepts, it helps to have an additional review of the material.

To help clarify these points, we return to our coffee shop example and now think of the coffee shop's assets—items the coffee shop owns or controls. Review the list of assets you created for the local coffee shop. Did you happen to notice many of the items on your list have one thing in common: the items will be used over a long period of time? In accounting, we classify assets based on whether or not the asset will be used or consumed within a certain period of time, generally one year. If the asset will be used or consumed in one year or less, we classify the asset as a **current asset**. If the asset will be used or consumed over more than one year, we classify the asset as a **noncurrent asset**.

Another thing you might have recognized when reviewing your list of coffee shop assets is that all of the items were something you could touch or move, each of which is known as a tangible asset. However, as you also learned in [Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate](#), not all assets are tangible. An asset could be an intangible asset, meaning the item lacks physical substance—it cannot be touched or moved. Take a moment to think about your favorite type of shoe or a popular type of farm tractor. Would you be able to recognize the maker of that shoe or the tractor by simply seeing the logo? Chances are you would. These are examples of intangible assets, trademarks to be precise. A trademark has value to the organization that created (or purchased) the trademark, and the trademark is something the organization controls—others cannot use the trademark without permission.

Similar to the accounting for assets, liabilities are classified based on the time frame in which the liabilities are expected to be settled. A liability that will be settled in one year or less (generally) is classified as a **current liability**, while a liability that is expected to be settled in more than one year is classified as a **noncurrent liability**.

Examples of current assets include **accounts receivable**, which is the outstanding customer debt on a credit sale; **inventory**, which is the value of products to be sold or items to be converted into sellable products; and sometimes a **notes receivable**, which is the value of amounts loaned that will be received in the future with interest, assuming that it will be paid within a year.

Examples of current liabilities include **accounts payable**, which is the value of goods or services purchased that will be paid for at a later date, and **notes payable**, which is the value of amounts borrowed (usually not inventory purchases) that will be paid in the future with interest.

Examples of noncurrent assets include notes receivable (notice notes receivable can be either current or noncurrent), land, buildings, equipment, and vehicles. An example of a noncurrent liability is notes payable (notice notes payable can be either current or noncurrent).

Why Does Current versus Noncurrent Matter?

At this point, let's take a break and explore why the distinction between current and noncurrent assets and liabilities matters. It is a good question because, on the surface, it does not seem to be important to make such a distinction. After all, assets are things owned or controlled by the organization, and liabilities are amounts owed by the organization; listing those amounts in the financial statements provides valuable information to stakeholders. But we have to dig a little deeper and remind ourselves that stakeholders are using this information to make decisions. Providing the amounts of the assets and liabilities answers the "what" question for stakeholders (that is, it tells stakeholders the value of assets), but it does not answer the "when" question for stakeholders. For example, knowing that an organization has \$1,000,000 worth of assets is valuable information, but knowing that \$250,000 of those assets are current and will be used or consumed within one year is more valuable to stakeholders. Likewise, it is helpful to know the company owes \$750,000 worth of liabilities, but knowing that \$125,000 of those liabilities will be paid within one year is even more valuable. In short, the *timing* of events is of particular interest to stakeholders.

THINK IT THROUGH

Borrowing

When money is borrowed by an individual or family from a bank or other lending institution, the loan is considered a personal or consumer loan. Typically, payments on these types of loans begin shortly after the funds are borrowed. Student loans are a special type of consumer borrowing that has a different structure for repayment of the debt. If you are not familiar with the special repayment arrangement for student loans, do a brief internet search to find out when student loan payments are expected to begin.

Now, assume a college student has two loans—one for a car and one for a student loan. Assume the person gets the flu, misses a week of work at his campus job, and does not get paid for the absence. Which loan would the person be most concerned about paying? Why?

Equity and Legal Structure

Recall that equity can also be referred to as net worth—the value of the organization. The concept of equity does not change depending on the legal structure of the business (sole proprietorship, partnership, and corporation). The terminology does, however, change slightly based on the type of entity. For example, investments by owners are considered “capital” transactions for sole proprietorships and partnerships but are considered “common stock” transactions for corporations. Likewise, distributions to owners are considered “drawing” transactions for sole proprietorships and partnerships but are considered “dividend” transactions for corporations.

As another example, in sole proprietorships and partnerships, the final amount of net income or net loss for the business becomes “Owner(s), Capital.” In a corporation, net income or net loss for the business becomes **retained earnings**, which is the cumulative, undistributed net income or net loss, less dividends paid for the business since its inception.

The essence of these transactions remains the same: organizations become *more* valuable when owners make investments in the business and the businesses earn a profit (net income), and organizations become *less* valuable when owners receive distributions (dividends) from the organization and the businesses incur a loss (net loss). Because accountants are providing information to stakeholders, it is important for accountants to fully understand the specific terminology associated with the various legal structures of organizations.

The Accounting Equation

Recall the simple example of a home loan discussed in [Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate](#). In that example, we assumed a family purchased a home valued at \$200,000 and made a down payment of \$25,000 while financing the remaining balance with a \$175,000 bank loan. This example demonstrates one of the most important concepts in the study of accounting: the **accounting equation**, which is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

In our example, the accounting equation would look like this:

$$\$200,000 = \$175,000 + \$25,000$$

As you continue your accounting studies and you consider the different major types of business entities available (sole proprietorships, partnerships, and corporations), there is another important concept for you to remember. This concept is that no matter which of the entity options that you choose, the accounting process for all of them will be predicated on the accounting equation.

It may be helpful to think of the accounting equation from a “sources and claims” perspective. Under this approach, the assets (items owned by the organization) were obtained by incurring liabilities or were provided by owners. Stated differently, every asset has a claim against it—by creditors and/or owners.

YOUR TURN

The Accounting Equation

On a sheet of paper, use three columns to create your own accounting equation. In the first column, list all of the things you own (assets). In the second column, list any amounts owed (liabilities). In the third column, using the accounting equation, calculate, you guessed it, the net amount of the asset (equity). When finished, total the columns to determine your net worth. Hint: do not forget to subtract the liability from the value of the asset.

Here is something else to consider: is it possible to have negative equity? It sure is . . . ask any college student who has taken out loans. At first glance there is no asset directly associated with the amount of the loan. But is that, in fact, the case? You might ask yourself why make an investment in a college education—what is the benefit (asset) to going to college? The answer lies in the difference in lifetime earnings with a college degree versus without a college degree. This is influenced by many things, including the supply and demand of jobs and employees. It is also influenced by the earnings for the type of college degree pursued. (Where do you think accounting ranks?)

Solution

Answers will vary but may include vehicles, clothing, electronics (include cell phones and computer/gaming systems, and sports equipment). They may also include money owed on these assets, most likely vehicles and perhaps cell phones. In the case of a student loan, there may be a liability with no corresponding asset (yet). Responses should be able to evaluate the benefit of investing in college is the wage differential between earnings with and without a college degree.

Expanding the Accounting Equation

Let's continue our exploration of the accounting equation, focusing on the equity component, in particular. Recall that we defined equity as the net worth of an organization. It is helpful to also think of net worth as the *value* of the organization. Recall, too, that revenues (inflows as a result of providing goods and services) *increase* the value of the organization. So, every dollar of revenue an organization generates increases the overall value of the organization.

Likewise, expenses (outflows as a result of generating revenue) *decrease* the value of the organization. So, each dollar of expenses an organization incurs decreases the overall value of the organization. The same approach can be taken with the other elements of the financial statements:

- Gains *increase* the value (equity) of the organization.
- Losses *decrease* the value (equity) of the organization.
- Investments by owners *increase* the value (equity) of the organization.
- Distributions to owners *decrease* the value (equity) of the organization.
- Changes in assets and liabilities can *either* increase or decrease the value (equity) of the organization depending on the net result of the transaction.

A graphical representation of this concept is shown in [Figure 2.4](#).

Assets				=	Liabilities				+	Owner's Equity	
Current		Noncurrent			Current		Noncurrent				
+	-	+	-		-	+	-	+		-	+
										Distribution to Owners	Investments by Owners
										Expenses	Revenues
										Losses	Gains
										Comprehensive Income	Comprehensive Income

Figure 2.4 Graphical Representation of the Accounting Equation. Both assets and liabilities are categorized as current and noncurrent. Also highlighted are the various activities that affect the equity (or net worth) of the business. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The format of this illustration is also intended to introduce you to a concept you will learn more about in your study of accounting. Notice each account subcategory (Current Assets and Noncurrent Assets, for example) has an “increase” side and a “decrease” side. These are called T-accounts and will be used to analyze transactions, which is the beginning of the accounting process. See [Analyzing and Recording Transactions](#) for a more comprehensive discussion of analyzing transactions and T-Accounts.

Not All Transactions Affect Equity

As you continue to develop your understanding of accounting, you will encounter many types of transactions involving different elements of the financial statements. The previous examples highlighted elements that change the equity of an organization. Not all transactions, however, ultimately impact equity. For example, the following do not impact the equity or net worth of the organization.^[10]

- Exchanges of assets for assets
- Exchanges of liabilities for liabilities
- Acquisitions of assets by incurring liabilities
- Settlements of liabilities by transferring assets

It is important to understand the inseparable connection between the elements of the financial statements and the possible impact on organizational equity (value). We explore this connection in greater detail as we return to the financial statements.

2.3 Prepare an Income Statement, Statement of Owner's Equity, and Balance Sheet

One of the key factors for success for those beginning the study of accounting is to understand how the elements of the financial statements relate to each of the financial statements. That is, once the transactions are categorized into the elements, knowing what to do next is vital. This is the beginning of the process to create the financial statements. It is important to note that financial statements are discussed in the order in which the statements are presented.

Elements of the Financial Statements

When thinking of the relationship between the elements and the financial statements, we might think of a baking analogy: the elements represent the ingredients, and the financial statements represent the finished product. As with baking a cake (see [Figure 2.5](#)), knowing the ingredients (elements) and how each ingredient relates to the final product (financial statements) is vital to the study of accounting.



Figure 2.5 Baking requires an understanding of the different ingredients, how the ingredients are used, and how the ingredients will impact the final product (a). If used correctly, the final product will be beautiful and, more importantly, delicious, like the cake shown in (b). In a similar manner, the study of accounting requires an understanding of how the accounting elements relate to the final product—the financial statements. (credit (a): modification of “U.S. Navy Culinary Specialist Seaman Robert Fritschie mixes cake batter aboard the amphibious command ship USS Blue Ridge (LCC 19) Aug. 7, 2013, while underway in the Solomon Sea 130807-N-NN332-044” by MC3 Jarred Harral/Wikimedia Commons, Public Domain; credit (b): modification of “Easter Cake with Colorful Topping” by Kaboompics .com/Pexels, CC0)

To help accountants prepare and users better understand financial statements, the profession has outlined what is referred to as **elements of the financial statements**, which are those categories or accounts that accountants use to record transactions and prepare financial statements. There are ten elements of the financial statements, and we have already discussed most of them.

- **Revenue**—value of goods and services the organization sold or provided.
- **Expenses**—costs of providing the goods or services for which the organization earns revenue.
- **Gains**—gains are similar to revenue but relate to “incidental or peripheral” activities of the organization.
- **Losses**—losses are similar to expenses but related to “incidental or peripheral” activities of the organization.
- **Assets**—items the organization owns, controls, or has a claim to.
- **Liabilities**—amounts the organization owes to others (also called creditors).
- **Equity**—the net worth (or net assets) of the organization.
- **Investment by owners**—cash or other assets provided to the organization in exchange for an ownership interest.

- **Distribution to owners**—cash, other assets, or ownership interest (equity) provided to owners.
- **Comprehensive income**—defined as the “change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources” (SFAC No. 6, p. 21). While further discussion of comprehensive income is reserved for intermediate and advanced studies in accounting, it is worth noting that comprehensive income has four components, focusing on activities related to foreign currency, derivatives, investments, and pensions.

Financial Statements for a Sample Company

Now it is time to bake the cake (i.e., prepare the financial statements). We have all of the ingredients (elements of the financial statements) ready, so let’s now return to the financial statements themselves. Let’s use as an example a fictitious company named Cheesy Chuck’s Classic Corn. This company is a small retail store that makes and sells a variety of gourmet popcorn treats. It is an exciting time because the store opened in the current month, June.

Assume that as part of your summer job with Cheesy Chuck’s, the owner—you guessed it, Chuck—has asked you to take over for a former employee who graduated college and will be taking an accounting job in New York City. In addition to your duties involving making and selling popcorn at Cheesy Chuck’s, part of your responsibility will be doing the accounting for the business. The owner, Chuck, heard that you are studying accounting and could really use the help, because he spends most of his time developing new popcorn flavors.

The former employee has done a nice job of keeping track of the accounting records, so you can focus on your first task of creating the June financial statements, which Chuck is eager to see. [Figure 2.6](#) shows the financial information (as of June 30) for Cheesy Chuck’s.

CHEESY CHUCK’S CLASSIC CORN Trial Balance For the Month Ended June 30, 2018	
Revenues	\$85,000
Expenses:	
Popcorn	22,800
Toppings and seasonings	17,300
Employee wages and benefits	10,700
Lease payments	24,000
Utilities	3,200
Advertising	900
Miscellaneous	300
Cash	\$ 6,200
Equipment	\$12,500
Accounts Payable	\$ 650
Wages Payable	\$ 1,200
Investment by Owner	\$12,500
Drawings by Owner	\$ (1,450)

Figure 2.6 Trial Balance for Cheesy Chuck’s Classic Corn. Accountants record and summarize accounting information into accounts, which help to track, summarize, and prepare accounting information. This table is a variation of what accountants call a “trial balance.” A trial balance is a summary of accounts and aids accountants in creating financial statements. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

We should note that we are oversimplifying some of the things in this example. First, the amounts in the accounting records were given. We did not explain how the amounts would be derived. This process is explained starting in [Analyzing and Recording Transactions](#). Second, we are ignoring the timing of certain cash flows such as hiring, purchases, and other startup costs. In reality, businesses must invest cash to prepare the store, train employees, and obtain the equipment and inventory necessary to open. These costs will precede the selling of goods and services. In the example to follow, for instance, we use Lease payments of \$24,000, which represents lease payments for the building (\$20,000) and equipment (\$4,000). In practice, when companies lease items, the accountants must determine, based on accounting rules, whether or not the business “owns” the item. If it is determined the business “owns” the building or equipment, the item is listed on the balance sheet at the original cost. Accountants also take into account the building or equipment’s value when the item is worn out. The difference in these two values (the original cost and the ending value) will be allocated over a relevant period of time. As an example, assume a business purchased equipment for \$18,000 and the equipment will be worth \$2,000 after four years, giving an estimated decline in value (due to usage) of \$16,000 ($\$18,000 - \$2,000$). The business will allocate \$4,000 of the equipment cost over each of the four years ($\$18,000$ minus $\$2,000$ over four years). This is called *depreciation* and is one of the topics that is covered in [Long-Term Assets](#).

Also, the Equipment with a value of \$12,500 in the financial information provided was purchased at the end of the first accounting period. It is an asset that will be depreciated in the future, but no depreciation expense is allocated in our example.

Income Statement

Let’s prepare the income statement so we can inform how Cheesy Chuck’s performed for the month of June (remember, an income statement is *for a period of time*). Our first step is to determine the value of goods and services that the organization sold or provided for a given period of time. These are the inflows to the business, and because the inflows relate to the primary purpose of the business (making and selling popcorn), we classify those items as Revenues, Sales, or Fees Earned. For this example, we use Revenue. The revenue for Cheesy Chuck’s for the month of June is \$85,000.

Next, we need to show the total expenses for Cheesy Chuck’s. Because Cheesy Chuck’s tracks different types of expenses, we need to add the amounts to calculate total expenses. If you added correctly, you get total expenses for the month of June of \$79,200. The final step to create the income statement is to determine the amount of net income or net loss for Cheesy Chuck’s. Since revenues (\$85,000) are greater than expenses (\$79,200), Cheesy Chuck’s has a net income of \$5,800 for the month of June.

[Figure 2.7](#) displays the June income statement for Cheesy Chuck’s Classic Corn.

CHEESY CHUCK'S CLASSIC CORN Income Statement For the Month Ended June 30, 2018		
Revenues		\$85,000
Expenses:		
Popcorn	\$22,800	
Toppings and seasonings	17,300	
Employee wages and benefits	10,700	
Lease payments	24,000	
Utilities	3,200	
Advertising	900	
Miscellaneous	<u>300</u>	
Total Expenses		\$79,200
Net Income		<u>\$ 5,800</u>

To be used
in Statement
of Owner's
Equity

Figure 2.7 Income Statement for Cheesy Chuck's Classic Corn. The income statement for Cheesy Chuck's shows the business had Net Income of \$5,800 for the month ended June 30. This amount will be used to prepare the next financial statement, the statement of owner's equity. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Financial statements are created using numerous standard conventions or practices. The standard conventions provide consistency and help assure financial statement users the information is presented in a similar manner, regardless of the organization issuing the financial statement. Let's look at the standard conventions shown in the Cheesy Chuck's income statement:

- The heading of the income statement includes three lines.
 - The first line lists the business name.
 - The middle line indicates the financial statement that is being presented.
 - The last line indicates the time frame of the financial statement. Do not forget the income statement is *for a period of time* (the month of June in our example).
- There are three columns.
 - Going from left to right, the first column is the category heading or account.
 - The second column is used when there are numerous accounts in a particular category (Expenses, in our example).
 - The third column is a total column. In this illustration, it is the column where subtotals are listed and net income is determined (subtracting Expenses from Revenues).
- Subtotals are indicated by a single underline, while totals are indicated by a double underline. Notice the amount of Miscellaneous Expense (\$300) is formatted with a single underline to indicate that a subtotal will follow. Similarly, the amount of "Net Income" (\$5,800) is formatted with a double underline to indicate that it is the final value/total of the financial statement.
- There are no gains or losses for Cheesy Chuck's. Gains and losses are not unusual transactions for businesses, but gains and losses may be infrequent for some, especially small, businesses.

CONCEPTS IN PRACTICE

McDonald's

For the year ended December 31, 2016, McDonald's had sales of \$24.6 billion.^[11] The amount of sales is often used by the business as the starting point for planning the next year. No doubt, there are a lot of people involved in the planning for a business the size of McDonald's. Two key people at McDonald's are the purchasing manager and the sales manager (although they might have different titles). Let's look at how McDonald's 2016 sales amount might be used by each of these individuals. In each case, do not forget that McDonald's is a global company.

A purchasing manager at McDonald's, for example, is responsible for finding suppliers, negotiating costs, arranging for delivery, and many other functions necessary to have the ingredients ready for the stores to prepare the food for their customers. Expecting that McDonald's will have over \$24 billion of sales during 2017, how many eggs do you think the purchasing manager at McDonald's would need to purchase for the year? According to the McDonald's website, the company uses over two billion eggs a year.^[12] Take a moment to list the details that would have to be coordinated in order to purchase and deliver over two billion eggs to the many McDonald's restaurants around the world.

A sales manager is responsible for establishing and attaining sales goals within the company. Assume that McDonald's 2017 sales are expected to exceed the amount of sales in 2016. What conclusions would you make based on this information? What do you think might be influencing these amounts? What factors do you think would be important to the sales manager in deciding what action, if any, to take? Now assume that McDonald's 2017 sales are expected to be below the 2016 sales level. What conclusions would you make based on this information? What do you think might be influencing these amounts? What factors do you think would be important to the sales manager in deciding what action, if any, to take?

Statement of Owner's Equity

Let's create the statement of owner's equity for Cheesy Chuck's for the month of June. Since Cheesy Chuck's is a brand-new business, there is no beginning balance of Owner's Equity. The first items to account for are the increases in value/equity, which are investments by owners and net income. As you look at the accounting information you were provided, you recognize the amount invested by the owner, Chuck, was \$12,500. Next, we account for the increase in value as a result of net income, which was determined in the income statement to be \$5,800. Next, we determine if there were any activities that decreased the value of the business. More specifically, we are accounting for the value of distributions to the owners and net loss, if any.

It is important to note that an organization will have either net income or net loss for the period, but not both. Also, small businesses in particular may have periods where there are no investments by, or distributions to, the owner(s). For the month of June, Chuck withdrew \$1,450 from the business. This is a good time to recall the

11 McDonald's Corporation. U.S. Securities and Exchange Commission 10-K Filing. March 1, 2017. <http://d18rn0p25nwr6d.cloudfront.net/CIK-0000063908/62200c2b-da82-4364-be92-79ed454e3b88.pdf>

12 McDonald's. "Our Food. Your Questions. Breakfast." n.d. <https://www.mcdonalds.com/us/en-us/about-our-food/our-food-your-questions/breakfast.html>

terminology used by accountants based on the legal structure of the particular business. Since the account was titled “Drawings by Owner” and because Chuck is the only owner, we can assume this is a sole proprietorship. If the business was structured as a corporation, this activity would be called something like “Dividends Paid to Owners.”

At this stage, remember that since we are working with a sole proprietorship to help simplify the examples, we have addressed the owner’s value in the firm as *capital* or *owner’s equity*. However, later we switch the structure of the business to a corporation, and instead of owner’s equity, we begin using such account titles as *common stock* and *retained earnings* to represent the owner’s interests. The corporate treatment is more complicated, because corporations may have a few owners up to potentially thousands of owners (stockholders). The details of accounting for the interests of corporations are covered in [Corporation Accounting](#).

So how much did the value of Cheesy Chuck’s change during the month of June? You are correct if you answered \$16,850. Since this is a brand-new store, the beginning value of the business is zero. During the month, the owner invested \$12,500 and the business had profitable operations (net income) of \$5,800. Also, during the month the owner withdrew \$1,450, resulting in a net change (and ending balance) to owner’s equity of \$16,850. Shown in a formula:

Beginning Balance + Investments by Owners ± Net Income (Net Loss) – Distributions, or

$$\$0 + \$12,500 + \$5,800 - \$1,450 = \$16,850$$

[Figure 2.8](#) shows what the statement of owner’s equity for Cheesy Chuck’s Classic Corn would look like.

CHEESY CHUCK’S CLASSIC CORN Statement of Owner’s Equity For the Month Ended June 30, 2018		
Chuck, Capital: June 1, 2018		\$ 0
Increases:		
Investments by owner	\$12,500	
Net income for month of June, 2018	<u>5,800</u>	
Total Increase		\$18,300
Decreases:		
Drawings by owner	<u>(1,450)</u>	
Net loss for month of June, 2018	<u>0</u>	
Total Decrease		\$(1,450)
Chuck, Capital: June 30, 2018		<u>\$16,850</u>

Obtained
from
Income
Statement

To be
used in
Balance
Sheet

Figure 2.8 Statement of Owner’s Equity for Cheesy Chuck’s Classic Corn. The statement of owner’s equity demonstrates how the net worth (also called equity) of the business changed over the period of time (the month of June in this case). Notice the amount of net income (or net loss) is brought from the income statement. In a similar manner, the ending equity balance (Capital for Cheesy Chuck’s because it is a sole proprietorship) is carried forward to the balance sheet. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Notice the following about the statement of owner’s equity for Cheesy Chuck’s:

- The format is similar to the format of the income statement (three lines for the heading, three columns).
- The statement follows a chronological order, starting with the first day of the month, accounting for the

changes that occurred throughout the month, and ending with the final day of the month.

The statement uses the final number from the financial statement previously completed. In this case, the statement of owner's equity uses the net income (or net loss) amount from the income statement (Net Income, \$5,800).

Balance Sheet

Let's create a balance sheet for Cheesy Chuck's for June 30. To begin, we look at the accounting records and determine what assets the business owns and the value of each. Cheesy Chuck's has two assets: Cash (\$6,200) and Equipment (\$12,500). Adding the amount of assets gives a total asset value of \$18,700. As discussed previously, the equipment that was recently purchased will be depreciated in the future, beginning with the next accounting period.

Next, we determine the amount of money that Cheesy Chuck's owes (liabilities). There are also two liabilities for Cheesy Chuck's. The first account listed in the records is Accounts Payable for \$650. Accounts Payable is the amount that Cheesy Chuck's must pay *in the future* to vendors (also called suppliers) for the ingredients to make the gourmet popcorn. The other liability is Wages Payable for \$1,200. This is the amount that Cheesy Chuck's must pay in the future to employees for work that has been performed. Adding the two amounts gives us total liabilities of \$1,850. (Here's a hint as you develop your understanding of accounting: Liabilities often include the word "payable." So, when you see "payable" in the account title, know these are amounts owed in the future—liabilities.)

Finally, we determine the amount of equity the owner, Cheesy Chuck, has in the business. The amount of owner's equity was determined on the statement of owner's equity in the previous step (\$16,850). Can you think of another way to confirm the amount of owner's equity? Recall that equity is also called net assets (assets minus liabilities). If you take the total assets of Cheesy Chuck's of \$18,700 and subtract the total liabilities of \$1,850, you get owner's equity of \$16,850. Using the basic accounting equation, the balance sheet for Cheesy Chuck's as of June 30 is shown in [Figure 2.9](#).

CHEESY CHUCK'S CLASSIC CORN			
Balance Sheet			
As of June 30, 2018			
Assets		Liabilities	
Cash	\$ 6,200	Accounts Payable	\$ 650
Equipment	<u>12,500</u>	Wages Payable	<u>1,200</u>
		Total Liabilities	\$ 1,850
		Owner's Equity	
		Cheesy Chuck, Capital	<u>16,850</u>
		Total Owner's Equity	\$ 16,850
Total Assets	<u>\$18,700</u>	Total Liabilities and Owner's Equity	<u>\$18,700</u>

Figure 2.9 Balance Sheet for Cheesy Chuck's Classic Corn. The balance sheet shows what the business owns (Assets), owes (Liabilities), and is worth (equity) on a given date. Notice the amount of Owner's Equity (Capital for Cheesy Chuck's) was brought forward from the statement of owner's equity. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Connecting the Income Statement and the Balance Sheet

Another way to think of the connection between the income statement and balance sheet (which is aided by

the statement of owner's equity) is by using a sports analogy. The income statement summarizes the financial *performance* of the business for a given period of time. The income statement reports how the business performed financially each month—the firm earned either net income or net loss. This is similar to the outcome of a particular game—the team either won or lost.

The balance sheet summarizes the financial *position* of the business on a given date. Meaning, because of the financial *performance* over the past twelve months, for example, this is the financial *position* of the business as of December 31. Think of the balance sheet as being similar to a team's overall win/loss record—to a certain extent a team's strength can be perceived by its win/loss record.

However, because different companies have different sizes, you do not necessarily want to compare the balance sheets of two different companies. For example, you would not want to compare a local retail store with Walmart. In most cases you want to compare a company with its past balance sheet information.

Statement of Cash Flows

In [Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate](#), we discussed the function of and the basic characteristics of the statement of cash flows. This fourth and final financial statement lists the cash inflows and cash outflows for the business *for a period of time*. It was created to fill in some informational gaps that existed in the other three statements (income statement, owner's equity/retained earnings statement, and the balance sheet). A full demonstration of the creation of the statement of cash flows is presented in [Statement of Cash Flows](#).

Creating Financial Statements: A Summary

In this example using a fictitious company, Cheesy Chuck's, we began with the account balances and demonstrated how to prepare the financial statements for the month of June, the first month of operations for the business. It will be helpful to revisit the process by summarizing the information we started with and how that information was used to create the four financial statements: income statement, statement of owner's equity, balance sheet, and statement of cash flows.

We started with the account balances shown in [Figure 2.10](#).

CHEESY CHUCK'S CLASSIC CORN Account Balances For the Month Ended June 30, 2018	
Revenues	\$85,000
Expenses:	
Popcorn	22,800
Toppings and seasonings	17,300
Employee wages and benefits	10,700
Lease payments	24,000
Utilities	3,200
Advertising	900
Miscellaneous	300
Cash	\$ 6,200
Equipment	\$12,500
Accounts Payable	\$ 650
Wages Payable	\$ 1,200
Investment by Owner	\$12,500
Drawings by Owner	\$ (1,450)

Figure 2.10 Account Balances for Cheesy Chuck's Classic Corn. Obtaining the account balances is the starting point for preparing financial statements. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The next step was to create the income statement, which shows the financial *performance* of the business. The income statement is shown in [Figure 2.11](#).

CHEESY CHUCK'S CLASSIC CORN Income Statement For the Month Ended June 30, 2018	
Revenues	\$85,000
Expenses:	
Popcorn	\$22,800
Toppings and seasonings	17,300
Employee wages and benefits	10,700
Lease payments	24,000
Utilities	3,200
Advertising	900
Miscellaneous	300
Total Expenses	\$79,200
Net Income	\$ 5,800

Figure 2.11 Income Statement for Cheesy Chuck's Classic Corn. The income statement uses information from the trial balance, which lists the accounts and account totals. The income statement shows the financial performance of a business for a period of time. The net income or net loss will be carried forward to the statement of owner's equity. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Next, we created the statement of owner's equity, shown in [Figure 2.12](#). The statement of owner's equity demonstrates how the equity (or net worth) of the business changed for the month of June. Do not forget that the Net Income (or Net Loss) is carried forward to the statement of owner's equity.

CHEESY CHUCK'S CLASSIC CORN Statement of Owner's Equity For the Month Ended June 30, 2018	
Chuck, Capital: June 1, 2018	\$ 0
Increases:	
Investments by owner	\$12,500
Net Income for month of June, 2018	<u>5,800</u>
Total Increase	\$18,300
Decreases:	
Drawings by owner	\$(1,450)
Total Decrease	<u>\$ (1,450)</u>
Chuck, Capital: June 30, 2018	\$16,850

Figure 2.12 Statement of Owner's Equity for Cheesy Chuck's Classic Corn. The statement of owner's equity shows how the net worth/value (or equity) of business changed for the period of time. This statement includes Net Income (or Net Loss), which was brought forward from the income statement. The ending balance is carried forward to the balance sheet. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The third financial statement created is the balance sheet, which shows the company's financial *position* on a given date. Cheesy Chuck's balance sheet is shown in [Figure 2.13](#).

CHEESY CHUCK'S CLASSIC CORN Balance Sheet As of June 30, 2018			
Assets		Liabilities	
Cash	\$ 6,200	Accounts Payable	\$ 650
Equipment	12,500	Wages Payable	1,200
		Total Liabilities	\$ 1,850
		Owner's Equity	
		Cheesy Chuck, Capital	16,850
		Total Owner's Equity	\$16,850
Total Assets	<u>\$18,700</u>	Total Liabilities and Owner's Equity	<u>\$18,700</u>

Figure 2.13 Balance Sheet for Cheesy Chuck's Classic Corn. The balance sheet shows the assets, liabilities, and owner's equity of a business on a given date. Notice the balance sheet is the accounting equation in financial statement form: Assets = Liabilities + Owner's Equity. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

THINK IT THROUGH

Financial Statement Analysis

In [Why It Matters](#), we pointed out that accounting information from the financial statements can be useful to business owners. The financial statements provide feedback to the owners regarding the financial performance and financial position of the business, helping the owners to make decisions about the business.

Using the June financial statements, analyze Cheesy Chuck's and prepare a brief presentation. Consider this from the perspective of the owner, Chuck. Describe the financial performance of and financial position of the business. What areas of the business would you want to analyze further to get additional information? What changes would you consider making to the business, if any, and why or why not?

ETHICAL CONSIDERATIONS

Financial Statement Manipulation at Waste Management Inc.

Accountants have an ethical duty to accurately report the financial results of their company and to ensure that the company's annual reports communicate relevant information to stakeholders. If accountants and company management fail to do so, they may incur heavy penalties.

For example, in 2002 the Securities and Exchange Commission (SEC) charged the top management of [Waste Management, Inc.](#) with inflating profits by \$1.7 billion to meet earnings targets in the period 1992–1997. An SEC press release alleged “that defendants fraudulently manipulated the company's financial results to meet predetermined earnings targets. . . . They employed a multitude of improper accounting practices to achieve this objective.”^[13] The defendants in the case manipulated reports to defer or eliminate expenses, which fraudulently inflated their earnings. Because they failed to accurately report the financial results of their company, the top accountants and management of [Waste Management, Inc.](#) face charges.

Thomas C. Newkirk, the associate director of the SEC's Division of Enforcement, stated, “For years, these defendants cooked the books, enriched themselves, preserved their jobs, and duped unsuspecting shareholders”^[14] The defendants, who included members of the company board and executives, benefited personally from their fraud in the millions of dollars through performance-based bonuses, charitable giving, and sale of company stock. The company's accounting firm, [Arthur Andersen](#), abetted the fraud by identifying the improper practices but doing little to stop them.

13 U.S. Securities and Exchange Commission. “Waste Management Founder, Five Other Former Top Officers Sued for Massive Fraud.” March 26, 2002. <https://www.sec.gov/news/headlines/wastemgmt6.htm>

14 U.S. Securities and Exchange Commission. “Waste Management Founder, Five Other Former Top Officers Sued for Massive Fraud.” March 26, 2002. <https://www.sec.gov/news/headlines/wastemgmt6.htm>

Liquidity Ratios

In addition to reviewing the financial statements in order to make decisions, owners and other stakeholders may also utilize financial ratios to assess the financial health of the organization. While a more in-depth discussion of financial ratios occurs in [Appendix A: Financial Statement Analysis](#), here we introduce *liquidity ratios*, a common, easy, and useful way to analyze the financial statements.

Liquidity refers to the business's ability to convert assets into cash in order to meet short-term cash needs. Examples of the most liquid assets include accounts receivable and inventory for merchandising or manufacturing businesses). The reason these are among the most liquid assets is that these assets will be turned into cash more quickly than land or buildings, for example. Accounts receivable represents goods or services that have already been sold and will typically be paid/collected within thirty to forty-five days. Inventory is less liquid than accounts receivable because the product must first be sold before it generates cash (either through a cash sale or sale on account). Inventory is, however, more liquid than land or buildings because, under most circumstances, it is easier and quicker for a business to find someone to purchase its goods than it is to find a buyer for land or buildings.

Working Capital

The starting point for understanding liquidity ratios is to define **working capital**—current assets minus current liabilities. Recall that current assets and current liabilities are amounts generally settled in one year or less. Working capital (current assets minus current liabilities) is used to assess the dollar amount of assets a business has available to meet its short-term liabilities. A positive working capital amount is desirable and indicates the business has sufficient current assets to meet short-term obligations (liabilities) and still has financial flexibility. A negative amount is undesirable and indicates the business should pay particular attention to the composition of the current assets (that is, how liquid the current assets are) and to the timing of the current liabilities. It is unlikely that all of the current liabilities will be due at the same time, but the amount of working capital gives stakeholders of both small and large businesses an indication of the firm's ability to meet its short-term obligations.

One limitation of working capital is that it is a dollar amount, which can be misleading because business sizes vary. Recall from the discussion on materiality that \$1,000, for example, is more material to a small business (like an independent local movie theater) than it is to a large business (like a movie theater chain). Using percentages or ratios allows financial statement users to more easily compare small and large businesses.

Current Ratio

The **current ratio** is closely related to working capital; it represents the current assets divided by current liabilities. The current ratio utilizes the same amounts as working capital (current assets and current liabilities) but presents the amount in ratio, rather than dollar, form. That is, the current ratio is defined as current assets/current liabilities. The interpretation of the current ratio is similar to working capital. A ratio of greater than one indicates that the firm has the ability to meet short-term obligations with a buffer, while a ratio of less than one indicates that the firm should pay close attention to the composition of its current assets as well as the timing of the current liabilities.

Sample Working Capital and Current Ratio Calculations

Assume that Chuck, the owner of Cheesy Chuck's, wants to assess the liquidity of the business. [Figure 2.14](#) shows the June 30, 2018, balance sheet. Assume the Equipment listed on the balance sheet is a noncurrent

asset. This is a reasonable assumption as this is the first month of operation and the equipment is expected to last several years. We also assume the Accounts Payable and Wages Payable will be paid within one year and are, therefore, classified as current liabilities.

CHEESY CHUCK'S CLASSIC CORN Balance Sheet As of June 30, 2018			
Assets		Liabilities	
Cash	\$ 6,200	Accounts Payable	\$ 650
Equipment	12,500	Wages Payable	1,200
		Total Liabilities	\$ 1,850
		Owner's Equity	
		Cheesy Chuck, Capital	16,850
		Total Owner's Equity	\$16,850
Total Assets	\$18,700	Total Liabilities and Owner's Equity	\$18,700

Figure 2.14 Balance Sheet for Cheesy Chuck's Classic Corn. The balance sheet provides a snapshot of the company's financial position. By showing the total assets, total liabilities, and total equity of the business, the balance sheet provides information that is useful for decision-making. In addition, using ratios can give stakeholders another view of the company, allowing for comparisons to prior periods and to other businesses. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Working capital is calculated as current assets minus current liabilities. Cheesy Chuck's has only two assets, and one of the assets, Equipment, is a noncurrent asset, so the value of current assets is the cash amount of \$6,200. The working capital of Cheesy Chuck's is \$6,200 – \$1,850 or \$4,350. Since this amount is over \$0 (it is well over \$0 in this case), Chuck is confident he has nothing to worry about regarding the liquidity of his business.

Let's further assume that Chuck, while attending a popcorn conference for store owners, has a conversation with the owner of a much larger popcorn store—Captain Caramel's. The owner of Captain Caramel's happens to share the working capital for his store is \$52,500. At first Chuck feels his business is not doing so well. But then he realizes that Captain Caramel's is located in a much bigger city (with more customers) and has been around for many years, which has allowed them to build a solid business, which Chuck aspires to do. How would Chuck compare the liquidity of his new business, opened just one month, with the liquidity of a larger and more-established business in another market? The answer is by calculating the current ratio, which removes the size differences (materiality) of the two businesses.

The current ratio is calculated as current assets/current liabilities. We use the same amounts that we used in the working capital calculation, but this time we divide the amounts rather than subtract the amounts. So Cheesy Chuck's current ratio is \$6,200 (current assets)/\$1,850 (current liabilities), or 3.35. This means that for every dollar of current liabilities, Cheesy Chuck's has \$3.35 of current assets. Chuck is pleased with the ratio but does not know how this compares to another popcorn store, so he asked his new friend from Captain Caramel's. The owner of Captain Caramel's shares that his store has a current ratio of 4.25. While it is still better than Cheesy Chuck's, Chuck is encouraged to learn that his store is performing at a more competitive level than he previously thought by comparing the dollar amounts of working capital.

IFRS CONNECTION

IFRS and US GAAP in Financial Statements

Understanding the elements that make up financial statements, the organization of those elements within the financial statements, and what information each statement relays is important, whether analyzing the financial statements of a US company or one from Honduras. Since most US companies apply generally accepted accounting principles (GAAP)^[15] as prescribed by the Financial Accounting Standards Board (FASB), and most international companies apply some version of the International Financial Reporting Standards (IFRS),^[16] knowing how these two sets of accounting standards are similar or different regarding the elements of the financial statements will facilitate analysis and decision-making.

Both IFRS and US GAAP have the same elements as components of financial statements: assets, liabilities, equity, income, and expenses. Equity, income, and expenses have similar subcategorization between the two types of GAAP (US GAAP and IFRS) as described. For example, income can be in the form of earned income (a lawyer providing legal services) or in the form of gains (interest earned on an investment account). The definition of each of these elements is similar between IFRS and US GAAP, but there are some differences that can influence the value of the account or the placement of the account on the financial statements. Many of these differences are discussed in detail later in this course when that element—for example, the nuances of accounting for liabilities—is discussed. Here is an example to illustrate how these minor differences in definition can impact placement within the financial statements when using US GAAP versus IFRS. ACME Car Rental Company typically rents its cars for a time of two years or 60,000 miles. At the end of whichever of these two measures occurs first, the cars are sold. Under both US GAAP and IFRS, the cars are noncurrent assets during the period when they are rented. Once the cars are being “held for sale,” under IFRS rules, the cars become current assets. However, under US GAAP, there is no specific rule as to where to list those “held for sale” cars; thus, they could still list the cars as noncurrent assets. As you learn more about the analysis of companies and financial information, this difference in placement on the financial statements will become more meaningful. At this point, simply know that financial analysis can include ratios, which is the comparison of two numbers, and thus any time you change the denominator or the numerator, the ratio result will change.

There are many similarities and some differences in the actual presentation of the various financial statements, but these are discussed in [The Adjustment Process](#) at which point these similarities and differences will be more meaningful and easier to follow.

15 Publicly traded companies in the United States must file their financial statements with the SEC, and those statements must be compiled using US GAAP. However, in some states, private companies can apply IFRS for SMEs (small and medium entities).

16 The following site identifies which countries require IFRS, which use a modified version of IFRS, and which countries prohibit the use of IFRS. <https://www.iasplus.com/en/resources/ifrs-topics/use-of-ifrs>

Key Terms

accounting equation $\text{assets} = \text{liabilities} + \text{owner's equity}$

accounts payable value of goods or services purchased that will be paid for at a later date

accounts receivable outstanding customer debt on a credit sale, typically receivable within a short time period

accrual basis accounting accounting system in which revenue is recorded or recognized when earned yet not necessarily received, and in which expenses are recorded when legally incurred and not necessarily when paid

asset tangible or intangible resource owned or controlled by a company, individual, or other entity with the intent that it will provide economic value

balance sheet financial statement that lists what the organization owns (assets), owes (liabilities), and is worth (equity) on a specific date

cash basis accounting method of accounting in which transactions are not recorded in the financial statements until there is an exchange of cash

common stock corporation's primary class of stock issued, with each share representing a partial claim to ownership or a share of the company's business

comprehensive income change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources

corporation legal business structure involving one or more individuals (owners) who are legally distinct (separate) from the business

current asset asset that will be used or consumed in one year or less

current liability debt or obligation due within one year or, in rare cases, a company's standard operating cycle, whichever is greater

current ratio current assets divided by current liabilities; used to determine a company's liquidity (ability to meet short-term obligations)

distribution to owner periodic "reward" distributed to owner of cash or other assets

dividend portion of the net worth (equity) that is returned to owners of a corporation as a reward for their investment

elements of the financial statements categories or groupings used to record transactions and prepare financial statements

equity residual interest in the assets of an entity that remains after deducting its liabilities

expense cost associated with providing goods or services

gain increase in organizational value from activities that are "incidental or peripheral" to the primary purpose of the business

income statement financial statement that measures the organization's financial performance for a given period of time

initial public offering (IPO) when a company issues shares of its stock to the public for the first time

intangible asset asset with financial value but no physical presence; examples include copyrights, patents, goodwill, and trademarks

inventory value of products to be sold or items to be converted into sellable products

investment by owner exchange of cash or other assets in exchange for an ownership interest in the organization

liability probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or

events

liquidity ability to convert assets into cash in order to meet primarily short-term cash needs or emergencies

long-term asset asset used ongoing in the normal course of business for more than one year that is not intended to be resold

long-term liability debt settled outside one year or one operating cycle, whichever is longer

loss decrease in organizational value from activities that are “incidental or peripheral” to the primary purpose of the business

net income when revenues and gains are greater than expenses and losses

net loss when expenses and losses are greater than revenues and gains

noncurrent asset asset that will be used or consumed over more than one year

noncurrent liability liability that is expected to be settled in more than one year

notes payable value of amounts borrowed that will be paid in the future with interest

notes receivable value of amounts loaned that will be received in the future with interest

partnership legal business structure consisting of an association of two or more people who contribute money, property, or services to operate as co-owners of a business

publicly traded company company whose stock is traded (bought and sold) on an organized stock exchange

retained earnings cumulative, undistributed net income or net loss for the business since its inception

revenue inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations

Securities and Exchange Commission (SEC) federal regulatory agency that regulates corporations with shares listed and traded on security exchanges through required periodic filings

short-term asset asset typically used up, sold, or converted to cash in one year or less

short-term liability liability typically expected to be paid within one year or less

sole proprietorship legal business structure consisting of a single individual

stakeholder someone affected by decisions made by a company; may include an investor, creditor, employee, manager, regulator, customer, supplier, and layperson

statement of cash flows financial statement listing the cash inflows and cash outflows for the business for a period of time

statement of owner's equity financial statement showing how the equity of the organization changed for a period of time

tangible asset asset that has physical substance

working capital current assets less current liabilities; sometimes used as a measure of liquidity



Summary

2.1 Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate

- Financial statements provide financial information to stakeholders to help them in making decisions.
- There are four financial statements: income statement, statement of owner's equity, balance sheet, and statement of cash flows.
- The income statement measures the financial *performance* of the organization for a period of time. The income statement lists revenues, expenses, gains, and losses, which make up net income (or net loss).
- The statement of owner's equity shows how the net worth of the organization changes for a period of time. In addition to showing net income or net loss, the statement of owner's equity shows the

investments by and distributions to owners.

- The balance sheet shows the organization's financial *position* on a given date. The balance sheet lists assets, liabilities, and owners' equity.
- The statement of cash flows shows the organization's cash inflows and cash outflows for a given period of time. The statement of cash flows is necessary because financial statements are usually prepared using *accrual* accounting, which records transactions when they occur rather than waiting until cash is exchanged.

2.2 Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses

- Assets and liabilities are categorized into current and noncurrent, based on when the item will be settled. Assets and liabilities that will be settled in one year or less are classified as current; otherwise, the items are classified as noncurrent.
- Assets are also categorized based on whether or not the asset has physical substance. Assets with physical substance are considered tangible assets, while intangible assets lack physical substance.
- The distinction between current and noncurrent assets and liabilities is important because it helps financial statement users assess the timing of the transactions.
- Three broad categories of legal business structures are sole proprietorship, partnership, and corporation, with each structure having advantages and disadvantages.
- The accounting equation is $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$. It is important to the study of accounting because it shows what the organization owns and the sources of (or claims against) those resources.
- Owners' equity can also be thought of as the net worth or value of the business. There are many factors that influence equity, including net income or net loss, investments by and distributions to owners, revenues, gains, losses, expenses, and comprehensive income.

2.3 Prepare an Income Statement, Statement of Owner's Equity, and Balance Sheet

- There are ten financial statement elements: revenues, expenses, gains, losses, assets, liabilities, equity, investments by owners, distributions to owners, and comprehensive income.
- There are standard conventions for the order of preparing financial statements (income statement, statement of owner's equity, balance sheet, and statement of cash flows) and for the format (three-line heading and columnar structure).
- Financial ratios, which are calculated using financial statement information, are often beneficial to aid in financial decision-making. Ratios allow for comparisons between businesses and determining trends between periods within the same business.
- Liquidity ratios assess the firm's ability to convert assets into cash.
- Working Capital ($\text{Current Assets} - \text{Current Liabilities}$) is a liquidity ratio that measures a firm's ability to meet current obligations.
- The Current Ratio ($\text{Current Assets} / \text{Current Liabilities}$) is similar to Working Capital but allows for comparisons between firms by determining the proportion of current assets to current liabilities.



Multiple Choice

1. **LO 2.1** Which of these statements is *not* one of the financial statements?
 - A. income statement
 - B. balance sheet
 - C. statement of cash flows
 - D. statement of owner investments
2. **LO 2.1** Stakeholders are less likely to include which of the following groups?
 - A. owners
 - B. employees
 - C. community leaders
 - D. competitors
3. **LO 2.1** Identify the correct components of the income statement.
 - A. revenues, losses, expenses, and gains
 - B. assets, liabilities, and owner's equity
 - C. revenues, expenses, investments by owners, distributions to owners
 - D. assets, liabilities, and dividends
4. **LO 2.1** The balance sheet lists which of the following?
 - A. assets, liabilities, and owners' equity
 - B. revenues, expenses, gains, and losses
 - C. assets, liabilities, and investments by owners
 - D. revenues, expenses, gains, and distributions to owners
5. **LO 2.1** Assume a company has a \$350 credit (not cash) sale. How would the transaction appear if the business uses *accrual* accounting?
 - A. \$350 would show up on the balance sheet as a sale.
 - B. \$350 would show up on the income statement as a sale.
 - C. \$350 would show up on the statement of cash flows as a cash outflow.
 - D. The transaction would not be reported because the cash was not exchanged.
6. **LO 2.2** Which of the following statements is true?
 - A. Tangible assets lack physical substance.
 - B. Tangible assets will be consumed in a year or less.
 - C. Tangible assets have physical substance.
 - D. Tangible assets will be consumed in over a year.
7. **LO 2.2** Owners have no personal liability under which legal business structure?
 - A. a corporation
 - B. a partnership
 - C. a sole proprietorship
 - D. There is liability in every legal business structure.

8. **L0 2.2** The accounting equation is expressed as _____.
A. Assets + Liabilities = Owner's Equity
B. Assets – Noncurrent Assets = Liabilities
C. Assets = Liabilities + Investments by Owners
D. Assets = Liabilities + Owner's Equity
9. **L0 2.2** Which of the following decreases owner's equity?
A. investments by owners
B. losses
C. gains
D. short-term loans
10. **L0 2.2** Exchanges of assets for assets have what effect on equity?
A. increase equity
B. may have no impact on equity
C. decrease equity
D. There is no relationship between assets and equity.
11. **L0 2.2** All of the following increase owner's equity *except* for which one?
A. gains
B. investments by owners
C. revenues
D. acquisitions of assets by incurring liabilities
12. **L0 2.3** Which of the following is not an element of the financial statements?
A. future potential sales price of inventory
B. assets
C. liabilities
D. equity
13. **L0 2.3** Which of the following is the correct order of preparing the financial statements?
A. income statement, statement of cash flows, balance sheet, statement of owner's equity
B. income statement, statement of owner's equity, balance sheet, statement of cash flows
C. income statement, balance sheet, statement of owner's equity, statement of cash flows
D. income statement, balance sheet, statement of cash flows, statement of owner's equity
14. **L0 2.3** The three heading lines of financial statements typically include which of the following?
A. company, statement title, time period of report
B. company headquarters, statement title, name of preparer
C. statement title, time period of report, name of preparer
D. name of auditor, statement title, fiscal year end
15. **L0 2.3** Which financial statement shows the financial *performance* of the company on a cash basis?
A. balance sheet
B. statement of owner's equity
C. statement of cash flows
D. income statement

16. **LO 2.3** Which financial statement shows the financial *position* of the company?

- A. balance sheet
- B. statement of owner's equity
- C. statement of cash flows
- D. income statement

17. **LO 2.3** Working capital is an indication of the firm's _____.

- A. asset utilization
- B. amount of noncurrent liabilities
- C. liquidity
- D. amount of noncurrent assets



Questions

1. **LO 2.1** Identify the four financial statements and describe the purpose of each.

2. **LO 2.1** Define the term *stakeholders*. Identify two stakeholder groups, and explain how each group might use the information contained in the financial statements.

3. **LO 2.1** Identify one similarity and one difference between revenues and gains. Why is this distinction important to stakeholders?

4. **LO 2.1** Identify one similarity and one difference between expenses and losses. Why is this distinction important to stakeholders?

5. **LO 2.1** Explain the concept of equity, and identify some activities that affect equity of a business.

6. **LO 2.2** Explain the difference between current and noncurrent assets and liabilities. Why is this distinction important to stakeholders?

7. **LO 2.2** Identify/discuss one similarity and one difference between tangible and intangible assets.

8. **LO 2.2** Name the three types of legal business structure. Describe one advantage and one disadvantage of each.

9. **LO 2.2** What is the "accounting equation"? List two examples of business transactions, and explain how the accounting equation would be impacted by these transactions.

10. **LO 2.3** Identify the order in which the four financial statements are prepared, and explain how the first three statements are interrelated.

11. **LO 2.3** Explain how the following items affect equity: revenue, expenses, investments by owners, and distributions to owners.

12. **LO 2.3** Explain the purpose of the statement of cash flows and why this statement is needed.



Exercise Set A

EA1. **L0** **2.1** For each independent situation below, calculate the missing values.

Revenues	-	Expenses	+	Gains	-	Losses	=	Net Income/(Loss)
\$ 1,250		\$ 1,100		\$ 125		\$ 75		?
?		100,755		0		1,550		\$ (485)
75,560		68,600		?		1,675		6,485
26,390		?		320		600		(990)
872,300		856,995		11,000		?		26,305

EA2. **L0** **2.1** For each independent situation below, calculate the missing values for owner's equity

Beginning Balance	+	Investments	-	Distributions	=	Ending Balance
\$ 0		\$ 22,750		\$ 12,000		?
17,630		?		7,500		\$ 66,330
?		75,300		163,200		138,900
0		175,300		?		159,530
85,800		62,750		43,900		?

EA3. **L0** **2.1** For each independent situation below, calculate the missing values.

Assets	-	Liabilities	=	Owner's Equity
\$ 32,000		\$ 17,000		?
168,700		?		\$146,300
17,500		16,830		?
?		232,000		330,700
382,170		?		125,270

EA4. **L0** **2.1** For each independent situation below, place an (X) by the transactions that would be included in the statement of cash flows.

Transaction	Included
Sold items on account	
Wrote check to pay utilities	
Received cash investment by owner	
Recorded wages owed to employees	
Received bill for advertising	

Table 2.3

EA5. **L0 2.2** For each of the following items, identify whether the item is considered current or noncurrent, and explain why.

Item	Current or Noncurrent?
Cash	
Inventory	
Machines	
Trademarks	
Accounts Payable	
Wages Payable	
Owner, Capital	
Accounts Receivable	

Table 2.4

EA6. **L0 2.2** For the items listed below, indicate how the item affects equity (increase, decrease, or no impact).

Item	Increase? Decrease? or No Impact?
Expenses	
Assets	
Gains	
Liabilities	
Dividends	

Table 2.5

EA7. **L0 2.2** Forest Company had the following transactions during the month of December. What is the December 31 cash balance?

Cash sales	\$3,250
Payments for inventory	1,760
Investments by owners	3,000
Supplies used	175
Cash withdrawals	260
Inventory received	2,500
Wages paid	2,390
Cash balance Dec. 1	4,250

EA8. **L0** 2.2 Here are facts for the Hudson Roofing Company for December.

Hudson Alexander, Capital Dec. 1	\$175,300
Dec. revenue	56,400
Dec. expenses	59,800

Assuming no investments or withdrawals, what is the ending balance in the owners' capital account?

EA9. **L0** 2.3 Prepare an income statement using the following information for DL Enterprises for the month of July 2018.

Sales revenue	\$62,500
Rental revenue	15,300
Product expense	52,200
Wages expense	18,900
Owner investment	12,000
Equipment purchases	56,000
Utilities expense	1,800
Taxes expense	400

EA10. **L0** 2.3 Prepare a statement of owner's equity using the information provided for Pirate Landing for the month of October 2018.

Cash	\$14,500
Pirate Pete, Capital Oct. 1	56,000
Net loss Oct. 2017	7,800
Owner investments	1,500
Wages payable	3,250
Supplies expense	750
Owner withdrawals	100

EA11. **L0** 2.3 Prepare a balance sheet using the following information for the Ginger Company as of March 31, 2019.

Accounts payable	\$ 1,730
Cash	11,050
Ginger Ale, Capital Mar. 1	17,300
Inventory	8,230
Wages payable	2,150
Sales	13,600
Product expenses	8,200
Ginger Ale, Capital Mar. 31	22,700
Equipment	7,300



Exercise Set B

EB1. **L0 2.1** For each independent situation below, calculate the missing values.

Revenues	-	Expenses	+	Gains	-	Losses	=	Net Income/(Loss)
\$ 1,813		\$ 1,595		\$ 181		\$ 109		?
?		146,095		\$ 0		2,248		\$ (703)
109,562		99,470		?		2,429		9,403
38,266		?		464		870		(1,436)
1,264,835		1,242,643		15,950		?		38,142

EB2. **L0 2.1** For each independent situation below, calculate the missing values for Owner's Equity.

Beginning Balance	+	Investments	-	Distributions	=	Ending Balance
\$ 0		\$ 14,333		\$ 7,560		?
11,107		?		4,725		\$ 41,788
?		47,439		102,816		87,507
0		110,439		?		100,504
54,054		39,533		27,657		?

EB3. **L0 2.1** For each independent situation below, calculate the missing values.

Assets	-	Liabilities	=	Owner's Equity
\$ 81,600		\$ 17,000		?
430,185		?		\$373,065
44,625		42,917		?
?		591,600		843,285
974,534		?		319,439

EB4. **L0 2.1** For each of the following independent situations, place an (X) by the transactions that would be included in the statement of cash flows.

Transaction	Included
Purchased supplies with check	
Received inventory (a bill was included)	
Paid cash to owner for withdrawal	
Gave cash donation to local charity	
Received bill for utilities	

Table 2.6

EB5. **L0 2.2** For each of the following items, identify whether the item is considered current or noncurrent, and explain why.

Item	Current or Noncurrent?
Inventory	
Buildings	
Accounts Receivable	
Cash	
Trademarks	
Accounts Payable	
Wages Payable	
Common Stock	

Table 2.7

EB6. **L0 2.2** For the items listed below, indicate how the item affects equity (increase, decrease, or no impact).

Item	Increase? Decrease? or No Impact?
Revenues	
Gains	
Losses	
Drawings	
Investments	

Table 2.8

EB7. **L0 2.2** Gumbo Company had the following transactions during the month of December. What was the December 1 cash balance?

Dividends paid	\$ 221
Credit sales	149
Payments for equipment	1,496
Taxes paid	2,032
Common stock sold	2,550
Inventory received	2,125
Cash sales	2,763
Cash balance Dec. 31	9,869

EB8. **L0** 2.2 Here are facts for Hailey's Collision Service for January.

Hailey Shusher, Capital Jan. 1	\$61,355
Jan. revenue	23,240
Jan. expenses	20,930

Assuming no investments or withdrawals, what is the ending balance in the owners' capital account?

EB9. **L0** 2.3 Prepare an income statement using the following information for CK Company for the month of February 2019.

Sales revenue	\$26,250
Rental revenue	6,426
Product expense	21,924
Wages expense	7,938
Owner investment	5,040
Equipment purchases	23,520
Utilities expense	756
Taxes expense	168

EB10. **L0** 2.3 Prepare a statement of owner's equity using the following information for the Can Due Shop for the month of September 2018.

Cash	\$ 51,040
Steve due, Capital Sep.1	197,120
Net income Sep. 2018	27,456
Owner investments	5,280
Wages payable	11,440
Supplies expense	2,640
Owner withdraws	352

EB11. **L0** 2.3 Prepare a balance sheet using the following information for Mike's Consulting as of January 31, 2019.

Accounts payable	\$ 570
Cash	3,646
Mike Michael, Capital Jan. 1	5,709
Inventory	2,716
Wages payable	710
Sales	4,488
Product expenses	2,706
Mike Michael, Capital Jan. 31	7,491
Equipment	2,409



Problem Set A

PA1. **L0 2.1** The following information is taken from the records of Baklava Bakery for the year 2019.

Revenues: Jan.	\$22,500
Gains: Feb.	1,200
Losses: Mar.	3,700
Expenses: Feb.	21,620
Gains: Jan.	0
Revenues: Mar.	42,800
Losses: Feb.	1,600
Expenses: Mar.	45,100
Losses: Jan.	0
Revenues: Feb.	37,550
Expenses: Jan.	20,760
Gains: Mar.	5,600

- Calculate net income or net loss for January.
- Calculate net income or net loss for February.
- Calculate net income or net loss for March.
- For each situation, comment on how a stakeholder might view the firm's performance. (Hint: Think about the source of the income or loss.)

PA2. **L0 2.1** Each situation below relates to an independent company's owners' equity.

	Beginning Balance	+ Net Income	- Net Loss	+ Investments	- Distributions	= Ending Balance
Co.1	?	\$16,500	\$ 0	\$22,300	\$ 1,750	\$ 37,050
Co.2	\$ 63,180	0	12,000	0	?	44,880
Co.3	275,300	?	0	0	24,100	299,400

- Calculate the missing values.
- Based on your calculations, make observations about each company.

PA3. **L0 2.1** The following information is from a new business. Comment on the year-to-year changes in the accounts and possible sources and uses of funds (how were the funds obtained and used).

	Assets	- Liabilities	= Owner's Equity
End of Year 1	\$245,000	\$120,000	\$125,000
End of Year 2	286,000	150,000	136,000
End of Year 3	212,000	80,000	132,000

PA4. **L0 2.1** Each of the following situations relates to a different company.

	Company A	Company B	Company C	Company D
1 Revenues	\$16,500	\$167,320	?	\$235,000
2 Expenses	12,400	?	\$72,300	241,000
3 Gains	750	1,350	0	?
4 Losses	900	6,240	5,200	0
5 Net Income or (Loss)	?	(9,250)	5,100	6,300

- For each of these independent situations, find the missing amounts.
- How would stakeholders view the financial performance of each company? Explain.

PA5. LO 2.2 For each of the following independent transactions, indicate whether there was an increase, a decrease, or no impact for each financial statement element.

Transaction	Assets	Liabilities	Owners' Equity
Paid cash for expenses			
Sold common stock for cash			
Owe vendor for purchase of asset			
Paid owners for dividends			
Paid vendor for amount previously owed			

Table 2.9

PA6. LO 2.2 Olivia's Apple Orchard had the following transactions during the month of September, the first month in business.

Transaction	Amount	Asset	-	Liability	=	Owner's Equity
Amount owed for land purchase	\$50,000	\$50,000		\$50,000		\$0
Apple sales: cash	3,000	?		?		?
Apple sales: credit	6,000	?		?		?
Collections of credit sales	4,000	?		?		?
Cash purchase of equipment	10,000	?		?		?
Owner investments	25,000	?		?		?
Wages expenses paid	6,000	?		?		?
Fuel expenses paid	400	?		?		?
Amount owed for utility expense	1,000	?		?		?
Current totals		\$50,000		\$50,000		\$0

Complete the chart to determine the ending balances. As an example, the first transaction has been completed. Note: Negative amounts should be indicated with minus signs (-) and unaffected should be noted as \$0.

(Hints: 1. each transaction will involve two financial statement elements; 2. the net impact of the transaction may be \$0.)

PA7. LO 2.2 Using the information in [PA6](#), determine the amount of revenue and expenses for Olivia's Apple Orchard for the month of September.

PA8. **LO 2.3** The following ten transactions occurred during the July grand opening of the Pancake Palace. Assume all Retained Earnings transactions relate to the primary purpose of the business.

	Assets			Liabilities		Owner's Equity	
	Cash	Inventory	Equipment	Accounts Payable	Wages Payable	Common Stock	Retained Earnings
1	\$50,000					\$50,000	
2	(6,000)	\$6,000					
3			\$22,000	\$22,000			
4	1,250						\$ 1,250
5	(750)						(750)
6				600			(600)
7					\$3,000		(3,000)
8	3,200						3,200
9				175			(175)
10	(1,000)		1,000				
Ending Balance							

- Calculate the ending balance for each account.
- Create the income statement.
- Create the statement of owner's equity.
- Create the balance sheet.



Problem Set B

PB1. **LO 2.1** The following information is taken from the records of Rosebloom Flowers for the year 2019.

Revenues: Jan.	\$36,425
Gains: Feb.	2,820
Losses: Mar.	8,695
Expenses: Feb.	50,807
Gains: Jan.	0
Revenues: Mar.	53,580
Losses: Feb.	3,760
Expenses: Mar.	58,985
Losses: Jan.	0
Revenues: Feb.	88,243
Expenses: Jan.	48,786
Gains: Mar.	13,160

- Calculate net income or net loss for January.
- Calculate net income or net loss for February.
- Calculate net income or net loss for March.
- For each situation, comment on how a stakeholder might view the firm's performance. (Hint: think about the source of the income or loss.)

PB2. **L0 2.1** Each situation below relates to an independent company's Owners' Equity.

	Beginning Balance	+ Net Income	- Net Loss	+ Investments	- Distributions	= Ending Balance
Co.1	\$163,800	\$16,500	\$ 0	?	\$ 1,750	\$254,150
Co.2	63,180	0	12,000	\$ 0	51,180	?
Co.3	0	0	?	150,000	0	101,400

- Calculate the missing values.
- Based on your calculations, make observations about each company.

PB3. **L0 2.1** The following information is from a new business. Comment on the year-to-year changes in the accounts and possible sources and uses funds (how were the funds obtained and used).

	Assets	- Liabilities	= Owner's Equity
End of Year 1	\$137,000	\$62,000	\$75,000
End of Year 2	148,000	57,000	91,000
End of Year 3	168,000	80,000	88,000

PB4. **L0 2.1** Each of the following situations relates to a different company.

	Company A	Company B	Company C	Company D
1 Revenues	?	\$1,480,500	\$103,950	\$1,054,116
2 Expenses	\$455,490	1,518,300	78,120	?
3 Gains	0	?	4,725	8,505
4 Losses	32,760	0	5,670	39,312
5 Net Income or (Loss)	<u>32,130</u>	<u>39,690</u>	<u>?</u>	<u>(58,275)</u>

- For each of these independent situations, find the missing amounts.
- How would stakeholders view the financial performance of each company? Explain.

PB5. **L0 2.2** For each of the following independent transactions, indicate whether there was an increase, decrease, or no impact on each financial statement element.

Transaction	Assets	Liabilities	Owners' Equity
Received cash for sale of asset (no gain or loss)			
Cash distribution to owner			
Cash sales			
Investment by owners			
Owe vendor for inventory purchase			

Table 2.10

PB6. [LO 2.2](#) Mateo's Maple Syrup had the following transactions during the month of February, its first month in business.

Transaction	Amount	Asset	-	Liability	=	Owner's Equity
Common stock sold	\$ 3,000	\$3,000		\$0		\$3,000
Amount owed for tax expense	1,950	?		?		?
Amount owed for insurance expense	750	?		?		?
Syrup sales: cash	13,000	?		?		?
Syrup sales: credit	6,000	?		?		?
Dividends paid	40	?		?		?
Collections of credit sales	1,700	?		?		?
Cash purchase for supplies expenses	250	?		?		?
Cash paid for amounts owed	1,600	?		?		?
Utility expenses paid	400	?		?		?
Taxes paid	600	?		?		?
		\$3,000		\$0		\$3,000

Complete the chart to determine the ending balances. As an example, the first transaction has been completed. Note: negative amounts should be indicated with minus signs (-).

(Hints: 1. each transaction will involve two financial statement elements; 2. the net impact of the transaction may be \$0.)

PB7. [LO 2.2](#) Using the information in [PB6](#), determine the amount of revenue and expenses for Mateo's Maple Syrup for the month of February.



Thought Provokers

TP1. [LO 2.1](#) Choose three stakeholders (or stakeholder groups) for **Walmart** and prepare a written response for each stakeholder. In your written response, consider the factors about the business the particular stakeholder would be interested in. Consider the financial and any nonfinancial factors that would be relevant to the stakeholder (or stakeholder group). Explain why these factors are important. Do some research and see if you can find support for your points.

TP2. [LO 2.1](#) Assume you purchased ten shares of **Roku** during the company's IPO. Comment on why this might be a good investment. Consider factors such as what you expect to get from your investment, why you think **Roku** would become a publicly traded company, and what you think is the landscape of the industry **Roku** is in. What other factors might be relevant to your decision to invest in **Roku**?

TP3. [LO 2.2](#) A trademark is an intangible asset that has value to a business. Assume that you are an accountant with the responsibility of valuing the trademark of a well-known company such as **Nike** or **McDonald's**. What makes each of these companies unique and adds value? While the value of a trademark may not necessarily be recorded on the company's balance sheet, discuss what factors you think would affect (increase or decrease) the value of the company's trademark? Consider your answer through the perspective of various stakeholders.

TP4. **L0 2.3** For each of the following ten independent transactions, provide a written description of what occurred in each transaction. [Figure 2.4](#) might help you.

	Assets			Liabilities		Owner's Equity	
	Cash	Inventory	Equipment	Accounts Payable	Wages Payable	Common Stock	Retained Earnings
1	\$57,500					\$57,500	
2	(6,900)	\$6,900					
3			\$25,300	\$25,300			
4	1,438						\$ 1,438
5	(863)						(863)
6				460			(460)
7					\$3,450		(3,450)
8	3,680						3,680
9				102			(102)
10	(1,150)		1,150				

TP5. **L0 2.3** The following historical information is from Assisi Community Markets.

	Current Assets			Current Liabilities	
	Cash	Accounts Receivable	Inventory	Accounts Payable	Wages Payable
Year 1	\$42,000	\$12,500	\$ 6,200	\$12,500	\$3,200
Year 2	37,500	16,800	7,600	14,600	3,700
Year 3	26,800	22,900	10,300	19,800	4,500
Year 4	22,100	28,000	15,400	20,600	6,000
Year 5	15,700	29,500	16,700	22,900	8,200

Calculate the working capital and current ratio for each year. What observations do you make, and what actions might the owner consider taking?

Analyzing and Recording Transactions

Figure 3.1 Dry-Cleaning Organization. Small businesses need an organized approach to recording daily business activities. (credit: modification of “Dry cleaned clothes Unsplash” by “m0851”/Wikimedia Commons, CC0)

Chapter Outline

- L0 3.1** Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements
- L0 3.2** Define and Describe the Expanded Accounting Equation and Its Relationship to Analyzing Transactions
- L0 3.3** Define and Describe the Initial Steps in the Accounting Cycle
- L0 3.4** Analyze Business Transactions Using the Accounting Equation and Show the Impact of Business Transactions on Financial Statements
- L0 3.5** Use Journal Entries to Record Transactions and Post to T-Accounts
- L0 3.6** Prepare a Trial Balance



Why It Matters

Mark Summers wants to start his own dry-cleaning business upon finishing college. He has chosen to name his business Supreme Cleaners. Before he embarks on this journey, Mark must establish what the new business will require. He needs to determine if he wants to have anyone invest in his company. He also needs to consider any loans that he might need to take out from his bank to fund the initial start-up. There are daily business activities that Mark will need to keep track of, such as sales, purchasing equipment, paying bills, collecting money from customers, and paying back investors, among other things. This process utilizes a standard accounting framework so that the financial operations are comparable to other company's financial operations.

He knows it is important for him to keep thorough documentation of these business activities to give his investors and creditors, and himself, a clear and accurate picture of operations. Without this, he may find it difficult to stay in business. He will maintain an organized record of all of Supreme Cleaners' financial activities from their inception, using an accounting process meant to result in accurate financial statement preparation.

3.1 Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements

If you want to start your own business, you need to maintain detailed and accurate records of business performance in order for you, your investors, and your lenders, to make informed decisions about the future of your company. Financial statements are created with this purpose in mind. A set of financial statements includes the income statement, statement of owner's equity, balance sheet, and statement of cash flows. These statements are discussed in detail in [Introduction to Financial Statements](#). This chapter explains the relationship between financial statements and several steps in the accounting process. We go into much more detail in [The Adjustment Process](#) and [Completing the Accounting Cycle](#).

Accounting Principles, Assumptions, and Concepts

In [Introduction to Financial Statements](#), you learned that the Financial Accounting Standards Board (FASB) is an independent, nonprofit organization that sets the standards for financial accounting and reporting, including generally accepted accounting principles (GAAP), for both public- and private-sector businesses in the United States.

As you may also recall, GAAP are the concepts, standards, and rules that guide the preparation and presentation of financial statements. If US accounting rules are followed, the accounting rules are called US GAAP. International accounting rules are called International Financial Reporting Standards (IFRS). Publicly traded companies (those that offer their shares for sale on exchanges in the United States) have the reporting of their financial operations regulated by the Securities and Exchange Commission (SEC).

You also learned that the SEC is an independent federal agency that is charged with protecting the interests of investors, regulating stock markets, and ensuring companies adhere to GAAP requirements. By having proper accounting standards such as US GAAP or IFRS, information presented publicly is considered comparable and reliable. As a result, financial statement users are more informed when making decisions. The SEC not only enforces the accounting rules but also delegates the process of setting standards for US GAAP to the FASB.

Some companies that operate on a global scale may be able to report their financial statements using IFRS. The SEC regulates the financial reporting of companies selling their shares in the United States, whether US GAAP or IFRS are used. The basics of accounting discussed in this chapter are the same under either set of guidelines.

ETHICAL CONSIDERATIONS

Auditing of Publicly Traded Companies

When a publicly traded company in the United States issues its financial statements, the financial

statements have been audited by a Public Company Accounting Oversight Board (PCAOB) approved auditor. The PCAOB is the organization that sets the auditing standards, after approval by the SEC. It is important to remember that auditing is not the same as accounting. The role of the Auditor is to examine and provide assurance that financial statements are reasonably stated under the rules of appropriate accounting principles. The auditor conducts the audit under a set of standards known as Generally Accepted Auditing Standards. The accounting department of a company and its auditors are employees of two different companies. The auditors of a company are required to be employed by a different company so that there is independence.

The nonprofit Center for Audit Quality explains auditor independence: “Auditors’ independence from company management is essential for a successful audit because it enables them to approach the audit with the necessary professional skepticism.”^[1] The center goes on to identify a key practice to protect independence by which an external auditor reports not to a company’s management, which could make it more difficult to maintain independence, but to a company’s audit committee. The audit committee oversees the auditors’ work and monitors disagreements between management and the auditor about financial reporting. Internal auditors of a company are not the auditors that provide an opinion on the financial statements of a company. According to the Center for Audit Quality, “By law, public companies’ annual financial statements are audited each year by independent auditors—accountants who examine the data for conformity with U.S. Generally Accepted Accounting Principles (GAAP).”^[2] The opinion from the independent auditors regarding a publicly traded company is filed for public inspection, along with the financial statements of the publicly traded company.

The Conceptual Framework

The FASB uses a **conceptual framework**, which is a set of concepts that guide financial reporting. These concepts can help ensure information is comparable and reliable to stakeholders. Guidance may be given on how to report transactions, measurement requirements, and application on financial statements, among other things.^[3]

IFRS CONNECTION

GAAP, IFRS, and the Conceptual Framework

The procedural part of accounting—recording transactions right through to creating financial statements—is a universal process. Businesses all around the world carry out this process as part of their normal operations. In carrying out these steps, the timing and rate at which transactions are recorded and subsequently reported in the financial statements are determined by the accepted accounting principles used by the company.

1 Center for Audit Quality. *Guide to Public Company Auditing*. <https://www.iasplus.com/en/binary/usa/aicpa/0905caqauditguide.pdf>

2 Center for Audit Quality. *Guide to Public Company Auditing*. <https://www.iasplus.com/en/binary/usa/aicpa/0905caqauditguide.pdf>

3 Financial Accounting Standards Board. “The Conceptual Framework.” <http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1176168367774>

As you learned in [Role of Accounting in Society](#), US-based companies will apply US GAAP as created by the FASB, and most international companies will apply IFRS as created by the International Accounting Standards Board (IASB). As illustrated in this chapter, the starting point for either FASB or IASB in creating accounting standards, or principles, is the conceptual framework. Both FASB and IASB cover the same topics in their frameworks, and the two frameworks are similar. The conceptual framework helps in the standard-setting process by creating the foundation on which those standards should be based. It can also help companies figure out how to record transactions for which there may not currently be an applicable standard. Though there are many similarities between the conceptual framework under US GAAP and IFRS, these similar foundations result in different standards and/or different interpretations.

Once an accounting standard has been written for US GAAP, the FASB often offers clarification on how the standard should be applied. Businesses frequently ask for guidance for their particular industry. When the FASB creates accounting standards and any subsequent clarifications or guidance, it only has to consider the effects of those standards, clarifications, or guidance on US-based companies. This means that FASB has only one major legal system and government to consider. When offering interpretations or other guidance on application of standards, the FASB can utilize knowledge of the US-based legal and taxation systems to help guide their points of clarification and can even create interpretations for specific industries. This means that interpretation and guidance on US GAAP standards can often contain specific details and guidelines in order to help align the accounting process with legal matters and tax laws.

In applying their conceptual framework to create standards, the IASB must consider that their standards are being used in 120 or more different countries, each with its own legal and judicial systems. Therefore, it is much more difficult for the IASB to provide as much detailed guidance once the standard has been written, because what might work in one country from a taxation or legal standpoint might not be appropriate in a different country. This means that IFRS interpretations and guidance have fewer detailed components for specific industries as compared to US GAAP guidance.

The conceptual framework sets the basis for accounting standards set by rule-making bodies that govern how the financial statements are prepared. Here are a few of the principles, assumptions, and concepts that provide guidance in developing GAAP.

Revenue Recognition Principle

The **revenue recognition principle** directs a company to recognize revenue in the period in which it is earned; revenue is not considered earned until a product or service has been provided. This means the period of time in which you performed the service or gave the customer the product is the period in which revenue is recognized.

There also does not have to be a correlation between when cash is collected and when revenue is recognized. A customer may not pay for the service on the day it was provided. Even though the customer has not yet paid cash, there is a reasonable expectation that the customer will pay in the future. Since the company has provided the service, it would recognize the revenue as earned, even though cash has yet to be collected.

For example, Lynn Sanders owns a small printing company, Printing Plus. She completed a print job for a customer on August 10. The customer did not pay cash for the service at that time and was billed for the service, paying at a later date. When should Lynn recognize the revenue, on August 10 or at the later payment

date? Lynn should record revenue as earned on August 10. She provided the service to the customer, and there is a reasonable expectation that the customer will pay at the later date.

Expense Recognition (Matching) Principle

The **expense recognition principle** (also referred to as the matching principle) states that we must match expenses with associated revenues in the period in which the revenues were earned. A mismatch in expenses and revenues could be an understated net income in one period with an overstated net income in another period. There would be no reliability in statements if expenses were recorded separately from the revenues generated.

For example, if Lynn earned printing revenue in April, then any associated expenses to the revenue generation (such as paying an employee) should be recorded on the same income statement. The employee worked for Lynn in April, helping her earn revenue in April, so Lynn must match the expense with the revenue by showing both on the April income statement.

Cost Principle

The **cost principle**, also known as the historical cost principle, states that virtually everything the company owns or controls (*assets*) must be recorded at its value at the date of acquisition. For most assets, this value is easy to determine as it is the price agreed to when buying the asset from the vendor. There are some exceptions to this rule, but always apply the cost principle unless FASB has specifically stated that a different valuation method should be used in a given circumstance.

The primary exceptions to this historical cost treatment, at this time, are financial instruments, such as stocks and bonds, which might be recorded at their fair market value. This is called mark-to-market accounting or fair value accounting and is more advanced than the general basic concepts underlying the introduction to basic accounting concepts; therefore, it is addressed in more advanced accounting courses.

Once an asset is recorded on the books, the value of that asset must remain at its historical cost, even if its value in the market changes. For example, Lynn Sanders purchases a piece of equipment for \$40,000. She believes this is a bargain and perceives the value to be more at \$60,000 in the current market. Even though Lynn feels the equipment is worth \$60,000, she may only record the cost she paid for the equipment of \$40,000.

Full Disclosure Principle

The **full disclosure principle** states that a business must report any business activities that could affect what is reported on the financial statements. These activities could be nonfinancial in nature or be supplemental details not readily available on the main financial statement. Some examples of this include any pending litigation, acquisition information, methods used to calculate certain figures, or stock options. These disclosures are usually recorded in footnotes on the statements, or in addenda to the statements.

Separate Entity Concept

The **separate entity concept** prescribes that a business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally. This concept is called the separate entity concept because the business is considered an entity separate and apart from its owner(s).

For example, Lynn Sanders purchases two cars; one is used for personal use only, and the other is used for business use only. According to the separate entity concept, Lynn may record the purchase of the car used by the company in the company's accounting records, but not the car for personal use.

Conservatism

This concept is important when valuing a transaction for which the dollar value cannot be as clearly determined, as when using the cost principle. **Conservatism** states that if there is uncertainty in a potential financial estimate, a company should err on the side of caution and report the most conservative amount. This would mean that any uncertain or estimated expenses/losses should be recorded, but uncertain or estimated revenues/gains should not. This understates net income, therefore reducing profit. This gives stakeholders a more reliable view of the company's financial position and does not overstate income.

Monetary Measurement Concept

In order to record a transaction, we need a system of **monetary measurement**, or a *monetary unit* by which to value the transaction. In the United States, this monetary unit is the US dollar. Without a dollar amount, it would be impossible to record information in the financial records. It also would leave stakeholders unable to make financial decisions, because there is no comparability measurement between companies. This concept ignores any change in the purchasing power of the dollar due to inflation.

Going Concern Assumption

The **going concern assumption** assumes a business will continue to operate in the foreseeable future. A common time frame might be twelve months. However, one should presume the business is doing well enough to continue operations unless there is evidence to the contrary. For example, a business might have certain expenses that are paid off (or reduced) over several time periods. If the business will stay operational in the foreseeable future, the company can continue to recognize these long-term expenses over several time periods. Some red flags that a business may no longer be a going concern are defaults on loans or a sequence of losses.

Time Period Assumption

The **time period assumption** states that a company can present useful information in shorter time periods, such as years, quarters, or months. The information is broken into time frames to make comparisons and evaluations easier. The information will be timely and current and will give a meaningful picture of how the company is operating.

For example, a school year is broken down into semesters or quarters. After each semester or quarter, your grade point average (GPA) is updated with new information on your performance in classes you completed. This gives you timely grading information with which to make decisions about your schooling.

A potential or existing investor wants timely information by which to measure the performance of the company, and to help decide whether to invest. Because of the time period assumption, we need to be sure to recognize revenues and expenses in the proper period. This might mean allocating costs over more than one accounting or reporting period.

The use of the principles, assumptions, and concepts in relation to the preparation of financial statements is better understood when looking at the full accounting cycle and its relation to the detailed process required to record business activities ([Figure 3.2](#)).

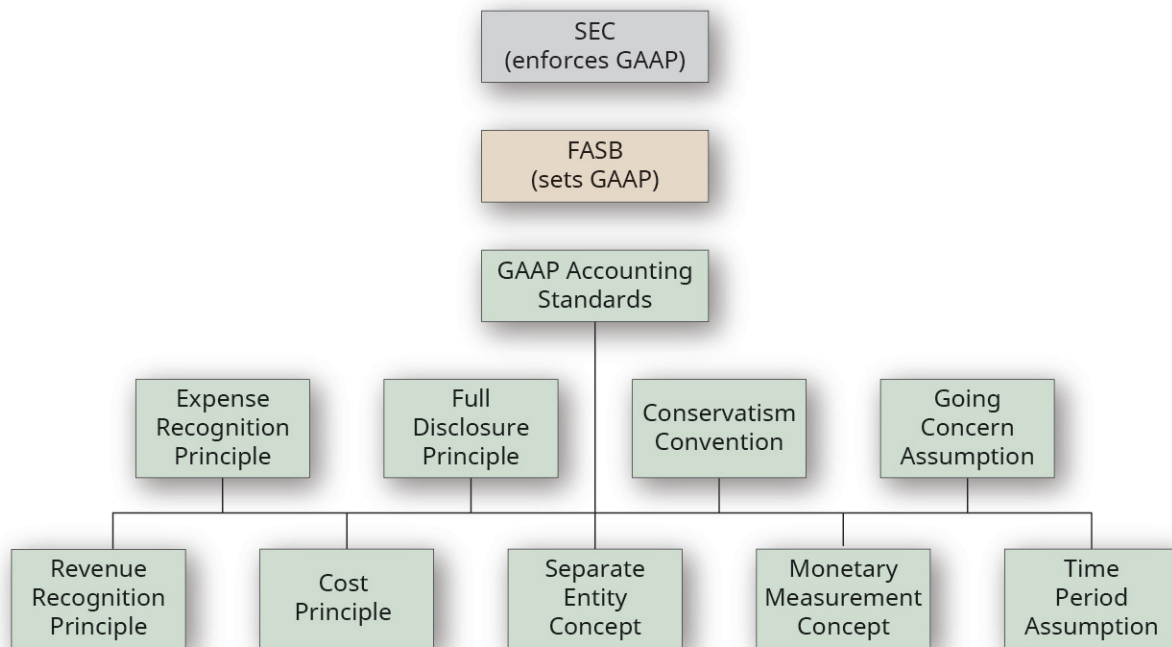


Figure 3.2 GAAP Accounting Standards Connection Tree. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

CONCEPTS IN PRACTICE

Tax Cuts and Jobs Act

In 2017, the US government enacted the Tax Cuts and Jobs Act. As a result, financial stakeholders needed to resolve several issues surrounding the standards from GAAP principles and the FASB. The issues were as follows: “Current Generally Accepted Accounting Principles (GAAP) requires that deferred tax liabilities and assets be adjusted for the effect of a change in tax laws or rates,” and “implementation issues related to the Tax Cuts and Jobs Act and income tax reporting.”^[4]

In response, the FASB issued updated guidance on both issues. You can explore these revised guidelines at the FASB website (https://www.fasb.org/taxcutsjobsact#section_1).

The Accounting Equation

[Introduction to Financial Statements](#) briefly discussed the accounting equation, which is important to the study of accounting because it shows what the organization owns and the sources of (or claims against) those resources. The accounting equation is expressed as follows:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

4 Financial Accounting Standards Board (FASB). “Accounting for the Tax Cuts and Jobs Act.” https://www.fasb.org/taxcutsjobsact#section_1

Recall that the accounting equation can be thought of from a “sources and claims” perspective; that is, the assets (items owned by the organization) were obtained by incurring liabilities or were provided by owners. Stated differently, everything a company owns must equal everything the company owes to creditors (lenders) and owners (individuals for sole proprietors or stockholders for companies or corporations).

In our example in [Why It Matters](#), we used an individual owner, Mark Summers, for the Supreme Cleaners discussion to simplify our example. Individual owners are sole proprietors in legal terms. This distinction becomes significant in such areas as legal liability and tax compliance. For sole proprietors, the owner’s interest is labeled “owner’s equity.”

In [Introduction to Financial Statements](#), we addressed the owner’s value in the firm as *capital* or *owner’s equity*. This assumed that the business is a sole proprietorship. However, for the rest of the text we switch the structure of the business to a corporation, and instead of owner’s equity, we begin using *stockholder’s equity*, which includes account titles such as *common stock* and *retained earnings* to represent the owners’ interests. The primary reason for this distinction is that the typical company can have several to thousands of owners, and the financial statements for corporations require a greater amount of complexity.

As you also learned in [Introduction to Financial Statements](#), the accounting equation represents the balance sheet and shows the relationship between assets, liabilities, and owners’ equity (for sole proprietorships/individuals) or common stock (for companies).

You may recall from mathematics courses that an equation must always be in balance. Therefore, we must ensure that the two sides of the accounting equation are always equal. We explore the components of the accounting equation in more detail shortly. First, we need to examine several underlying concepts that form the foundation for the accounting equation: the double-entry accounting system, debits and credits, and the “normal” balance for each account that is part of a formal accounting system.

Double-Entry Bookkeeping

The basic components of even the simplest accounting system are *accounts* and a *general ledger*. An **account** is a record showing increases and decreases to assets, liabilities, and equity—the basic components found in the accounting equation. As you know from [Introduction to Financial Statements](#), each of these categories, in turn, includes many individual accounts, all of which a company maintains in its general ledger. A **general ledger** is a comprehensive listing of all of a company’s accounts with their individual balances.

Accounting is based on what we call a **double-entry accounting system**, which requires the following:

- Each time we record a transaction, we must record a change in at least two different accounts. Having two or more accounts change will allow us to keep the accounting equation in balance.
- Not only will at least two accounts change, but there must also be at least one debit and one credit side impacted.
- The sum of the debits must equal the sum of the credits for each transaction.

In order for companies to record the myriad of transactions they have each year, there is a need for a simple but detailed system. Journals are useful tools to meet this need.

Debits and Credits

Each account can be represented visually by splitting the account into left and right sides as shown. This graphic representation of a general ledger account is known as a **T-account**. The concept of the T-account was

briefly mentioned in [Introduction to Financial Statements](#) and will be used later in this chapter to analyze transactions. A T-account is called a “T-account” because it looks like a “T,” as you can see with the T-account shown here.

Account Title (such as Cash or Accounts Payable)	
Debit	Credit

A **debit** records financial information on the left side of each account. A **credit** records financial information on the right side of an account. One side of each account will increase and the other side will decrease. The **ending account balance** is found by calculating the difference between debits and credits for each account. You will often see the terms *debit* and *credit* represented in shorthand, written as *DR* or *dr* and *CR* or *cr*, respectively. Depending on the account type, the sides that increase and decrease may vary. We can illustrate each account type and its corresponding debit and credit effects in the form of an *expanded accounting equation*. You will learn more about the expanded accounting equation and use it to analyze transactions in [Define and Describe the Expanded Accounting Equation and Its Relationship to Analyzing Transactions](#).

Assets		=		Liabilities		+		Common Stock		-		Dividends		+		Revenues		-		Expenses	
Debit	Credit			Debit	Credit			Debit	Credit			Debit	Credit			Debit	Credit			Debit	Credit
Increase	Decrease			Decrease	Increase			Decrease	Increase			Increase	Decrease			Decrease	Increase			Increase	Decrease

As we can see from this expanded accounting equation, Assets accounts increase on the debit side and decrease on the credit side. This is also true of Dividends and Expenses accounts. Liabilities increase on the credit side and decrease on the debit side. This is also true of Common Stock and Revenues accounts. This becomes easier to understand as you become familiar with the *normal balance* of an account.

Normal Balance of an Account

The **normal balance** is the expected balance each account type maintains, which is the side that increases. As assets and expenses increase on the debit side, their normal balance is a debit. Dividends paid to shareholders also have a normal balance that is a debit entry. Since liabilities, equity (such as common stock), and revenues increase with a credit, their “normal” balance is a credit. [Table 3.1](#) shows the normal balances and increases for each account type.

Account Normal Balances and Increases

Type of account	Increases with	Normal balance
Asset	Debit	Debit
Liability	Credit	Credit
Common Stock	Credit	Credit
Dividends	Debit	Debit

Table 3.1

Account Normal Balances and Increases

Type of account	Increases with	Normal balance
Revenue	Credit	Credit
Expense	Debit	Debit

Table 3.1

When an account produces a balance that is contrary to what the expected normal balance of that account is, this account has an **abnormal balance**. Let's consider the following example to better understand abnormal balances.

Let's say there were a credit of \$4,000 and a debit of \$6,000 in the Accounts Payable account. Since Accounts Payable increases on the credit side, one would expect a normal balance on the credit side. However, the difference between the two figures in this case would be a debit balance of \$2,000, which is an abnormal balance. This situation could possibly occur with an overpayment to a supplier or an error in recording.

CONCEPTS IN PRACTICE

Assets

We define an asset to be a resource that a company owns that has an economic value. We also know that the employment activities performed by an employee of a company are considered an expense, in this case a salary expense. In baseball, and other sports around the world, players' contracts are consistently categorized as assets that lose value over time (they are amortized).

For example, the **Texas Rangers** list "Player rights contracts and signing bonuses-net" as an asset on its balance sheet. They decrease this asset's value over time through a process called *amortization*. For tax purposes, players' contracts are treated akin to office equipment even though expenses for player salaries and bonuses have already been recorded. This can be a point of contention for some who argue that an owner does not assume the lost value of a player's contract, the player does.^[5]

3.2 Define and Describe the Expanded Accounting Equation and Its Relationship to Analyzing Transactions

Before we explore how to analyze transactions, we first need to understand what governs the way transactions are recorded.

As you have learned, the accounting equation represents the idea that a company needs assets to operate, and there are two major sources that contribute to operations: liabilities and equity. The company borrows the funds, creating liabilities, or the company can take the funds provided by the profits generated in the current or past periods, creating retained earnings or some other form of stockholder's equity. Recall the accounting

5 Tommy Craggs. "MLB Confidential, Part 3: Texas Rangers." Deadspin. August 24, 2010. <https://deadspin.com/5619951/mlb-confidential-part-3-texas-rangers>

equation's basic form.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Expanded Accounting Equation

The **expanded accounting equation** breaks down the equity portion of the accounting equation into more detail. This expansion of the equity section allows a company to see the impact to equity from changes to revenues and expenses, and to owner investments and payouts. It is important to have more detail in this equity category to understand the effect on financial statements from period to period. For example, an increase to revenue can increase net income on the income statement, increase retained earnings on the statement of retained earnings, and change the distribution of stockholder's equity on the balance sheet. This may be difficult to understand where these changes have occurred without revenue recognized individually in this expanded equation.

The expanded accounting equation is shown here.

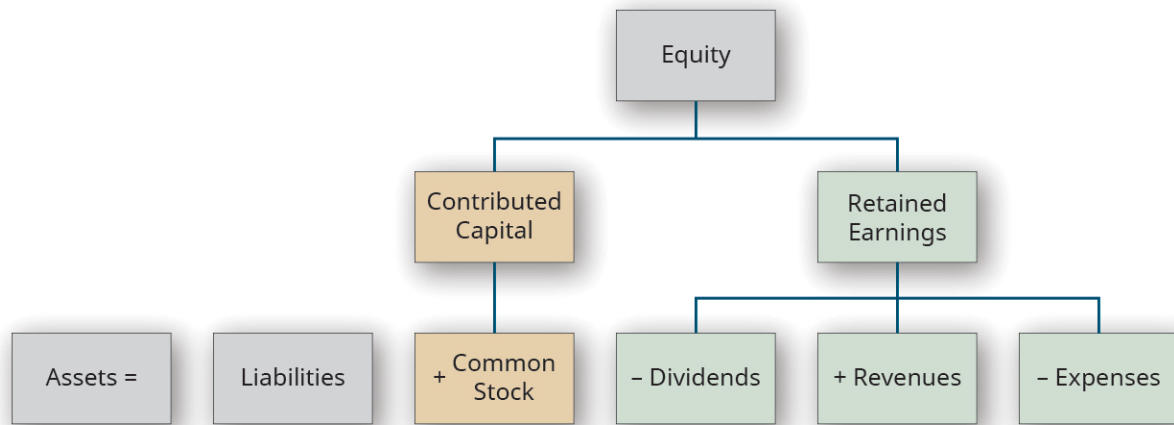


Figure 3.3 Expanded Accounting Equation. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Note that this expanded accounting equation breaks down Equity into four categories: common stock, dividends, revenues, and expenses. This considers each element of contributed capital and retained earnings individually to better illustrate each one's impact on changes in equity.

A business can now use this equation to analyze transactions in more detail. But first, it may help to examine the many accounts that can fall under each of the main categories of Assets, Liabilities, and Equity, in terms of their relationship to the expanded accounting equation. We can begin this discussion by looking at the *chart of accounts*.

Chart of Accounts

Recall that the basic components of even the simplest accounting system are accounts and a general ledger. Accounts shows all the changes made to assets, liabilities, and equity—the three main categories in the accounting equation. Each of these categories, in turn, includes many individual accounts, all of which a company maintains in its general ledger.

When a company first starts the analysis process, it will make a list of all the accounts used in day-to-day transactions. For example, a company may have accounts such as cash, accounts receivable, supplies, accounts payable, unearned revenues, common stock, dividends, revenues, and expenses. Each company will make a list that works for its business type, and the transactions it expects to engage in. The accounts may receive numbers using the system presented in [Table 3.2](#).

Account Numbering System

Account category	Assigned account number will start with	Account numbers for a small company	Account numbers for a large company
Assets	1	100–199	1000–1999
Liabilities	2	200–299	2000–2999
Stockholders' equity	3	300–399	3000–3999
Revenues	4	400–499	4000–4999
Expenses	5	500–599	5000–5999

Table 3.2

We call this account numbering system a **chart of accounts**. The accounts are presented in the chart of accounts in the order in which they appear on the financial statements, beginning with the balance sheet accounts and then the income statement accounts. Additional numbers starting with six and continuing might be used in large merchandising and manufacturing companies. The information in the chart of accounts is the foundation of a well-organized accounting system.

Breaking Down the Expanded Accounting Equation

Refer to the expanded accounting equation ([Figure 3.3](#)). We begin with the left side of the equation, the assets, and work toward the right side of the equation to liabilities and equity.

Assets and the Expanded Accounting Equation

On the left side of the equation are assets. Assets are resources a company owns that have an economic value. Assets are represented on the balance sheet financial statement. Some common examples of assets are cash, accounts receivable, inventory, supplies, prepaid expenses, notes receivable, equipment, buildings, machinery, and land.

Cash includes paper currency as well as coins, checks, bank accounts, and money orders. Anything that can be quickly liquidated into cash is considered cash. Cash activities are a large part of any business, and the flow of cash in and out of the company is reported on the statement of cash flows.

Accounts receivable is money that is owed to the company, usually from a customer. The customer has not yet paid with cash for the provided good or service but will do so in the future. Common phrasing to describe this situation is that a customer purchased something “on account,” meaning that the customer has asked to be

billed and will pay at a later date: “Account” because a customer has not paid us yet but instead has asked to be billed; “Receivable” because we will receive the money in the future.

Inventory refers to the goods available for sale. Service companies do not have goods for sale and would thus not have inventory. Merchandising and manufacturing businesses do have inventory. You learn more about this topic in [Inventory](#).

Examples of supplies (office supplies) include pens, paper, and pencils. Supplies are considered assets until an employee uses them. At the point they are used, they no longer have an economic value to the organization, and their cost is now an expense to the business.

Prepaid expenses are items paid for in advance of their use. They are considered assets until used. Some examples can include insurance and rent. Insurance, for example, is usually purchased for more than one month at a time (six months typically). The company does not use all six months of the insurance at once, it uses it one month at a time. However, the company prepays for all of it up front. As each month passes, the company will adjust its records to reflect the cost of one month of insurance usage.

Notes receivable is similar to accounts receivable in that it is money owed to the company by a customer or other entity. The difference here is that a note typically includes interest and specific contract terms, and the amount may be due in more than one accounting period.

Equipment examples include desks, chairs, and computers; anything that has a long-term value to the company that is used in the office. Equipment is considered a long-term asset, meaning you can use it for more than one accounting period (a year for example). Equipment will lose value over time, in a process called *depreciation*. You will learn more about this topic in [The Adjustment Process](#).

Buildings, machinery, and land are all considered long-term assets. Machinery is usually specific to a manufacturing company that has a factory producing goods. Machinery and buildings also depreciate. Unlike other long-term assets such as machinery, buildings, and equipment, land is not depreciated. The process to calculate the loss on land value could be very cumbersome, speculative, and unreliable; therefore, the treatment in accounting is for land to *not* be depreciated over time.



Figure 3.4 Assets. Cash, buildings, inventory, and equipment are all types of assets. (credit clockwise from top left: modification of “Cash money! 140606-A-CA521-021” by Sgt. Michael Selvage/Wikimedia Commons, Public Domain; modification of “41 Cherry Orchard Road” by “Pafcool2”/Wikimedia Commons, Public Domain; modification of “ASM-e1516805109201” by Jeff Green, Rethink Robotics/ Wikimedia Commons, CC BY 4.0; modification of “Gfp-inventory-space” by Yinan Chen/Wikimedia Commons, CC0)

Liabilities and the Expanded Accounting Equation

The accounting equation emphasizes a basic idea in business; that is, businesses need assets in order to operate. There are two ways a business can finance the purchase of assets. First, it can sell shares of its stock to the public to raise money to purchase the assets, or it can use profits earned by the business to finance its activities. Second, it can borrow the money from a lender such as a financial institution. You will learn about other assets as you progress through the book. Let’s now take a look at the right side of the accounting equation.

Liabilities are obligations to pay an amount owed to a lender (creditor) based on a past transaction. Liabilities are reported on the balance sheet. It is important to understand that when we talk about liabilities, we are not just talking about loans. Money collected for gift cards, subscriptions, or as advance deposits from customers could also be liabilities. Essentially, anything a company owes and has yet to pay within a period is considered a liability, such as salaries, utilities, and taxes.

For example, a company uses \$400 worth of utilities in May but is not billed for the usage, or asked to pay for the usage, until June. Even though the company does not have to pay the bill until June, the company owed money for the usage that occurred in May. Therefore, the company must record the usage of electricity, as well as the liability to pay the utility bill, in May.

Eventually that debt must be repaid by performing the service, fulfilling the subscription, or providing an asset such as merchandise or cash. Some common examples of liabilities include accounts payable, notes payable, and unearned revenue.

Accounts payable recognizes that the company owes money and has not paid. Remember, when a customer purchases something “on account” it means the customer has asked to be billed and will pay at a later date. In this case the purchasing company is the “customer.” The company will have to pay the money due in the future, so we use the word “payable.” The debt owed is usually paid off in less than one accounting period (less than a year typically) if it is classified as an account payable.

A notes payable is similar to accounts payable in that the company owes money and has not yet paid. Some key differences are that the contract terms are usually longer than one accounting period, interest is included, and there is typically a more formalized contract that dictates the terms of the transaction.

Unearned revenue represents a customer’s advanced payment for a product or service that has yet to be provided by the company. Since the company has not yet provided the product or service, it cannot recognize the customer’s payment as revenue, according to the revenue recognition principle. Thus, the account is called unearned revenue. The company owing the product or service creates the liability to the customer.

Equity and the Expanded Accounting Equation

Stockholder’s equity refers to the owner’s (stockholders) investments in the business and earnings. These two components are contributed capital and retained earnings.

The owner’s investments in the business typically come in the form of common stock and are called **contributed capital**. There is a hybrid owner’s investment labeled as preferred stock that is a combination of debt and equity (a concept covered in more advanced accounting courses). The company will issue shares of common stock to represent stockholder ownership. You will learn more about common stock in [Corporation Accounting](#).

Another component of stockholder’s equity is company earnings. These retained earnings are what the company holds onto at the end of a period to reinvest in the business, after any distributions to ownership occur. Stated more technically, retained earnings are a company’s cumulative earnings since the creation of the company minus any dividends that it has declared or paid since its creation. One tricky point to remember is that retained earnings are not classified as assets. Instead, they are a component of the stockholder’s equity account, placing it on the right side of the accounting equation.

Distribution of earnings to ownership is called a dividend. The dividend could be paid with cash or be a distribution of more company stock to current shareholders. Either way, dividends will decrease retained earnings.

Also affecting retained earnings are revenues and expenses, by way of net income or net loss. Revenues are earnings from the sale of goods and services. An increase in revenues will also contribute toward an increase in retained earnings. Expenses are the cost of resources associated with earning revenues. An increase to expenses will contribute toward a decrease in retained earnings. Recall that this concept of recognizing expenses associated with revenues is the expense recognition principle. Some examples of expenses include bill payments for utilities, employee salaries, and loan interest expense. A business does not have an expense until it is “incurred.” Incurred means the resource is used or consumed. For example, you will not recognize utilities as an expense until you have used the utilities. The difference between revenues earned and expenses incurred is called net income (loss) and can be found on the income statement.

Net income reported on the income statement flows into the statement of retained earnings. If a business has net income (earnings) for the period, then this will increase its retained earnings for the period. This means that revenues exceeded expenses for the period, thus increasing retained earnings. If a business has net loss for the period, this decreases retained earnings for the period. This means that the expenses exceeded the revenues for the period, thus decreasing retained earnings.

You will notice that stockholder's equity increases with common stock issuance and revenues, and decreases from dividend payouts and expenses. Stockholder's equity is reported on the balance sheet in the form of contributed capital (common stock) and retained earnings. The statement of retained earnings computes the retained earnings balance at the beginning of the period, adds net income or subtracts net loss from the income statement, and subtracts dividends declared, to result in an ending retained earnings balance reported on the balance sheet.

Now that you have a basic understanding of the accounting equation, and examples of assets, liabilities, and stockholder's equity, you will be able to analyze the many transactions a business may encounter and determine how each transaction affects the accounting equation and corresponding financial statements. First, however, in [Define and Examine the Initial Steps in the Accounting Cycle](#) we look at how the role of identifying and analyzing transactions fits into the continuous process known as the *accounting cycle*.

LINK TO LEARNING

The Financial Accounting Standards Board had a policy that allowed companies to reduce their tax liability from share-based compensation deductions. This led companies to create what some call the “contentious debit,” to defer tax liability and increase tax expense in a current period. See the [article “The contentious debit—seriously” on continuous debt \(https://openstax.org/l/50ContDebt\)](https://openstax.org/l/50ContDebt) for further discussion of this practice.

3.3

Define and Describe the Initial Steps in the Accounting Cycle

This chapter on analyzing and recording transactions is the first of three consecutive chapters (including [The Adjustment Process](#) and [Completing the Accounting Cycle](#)) covering the steps in one continuous process known as the accounting cycle. The **accounting cycle** is a step-by-step process to record business activities and events to keep financial records up to date. The process occurs over one accounting period and will begin the cycle again in the following period. A **period** is one operating cycle of a business, which could be a month, quarter, or year. Review the accounting cycle in [Figure 3.5](#).

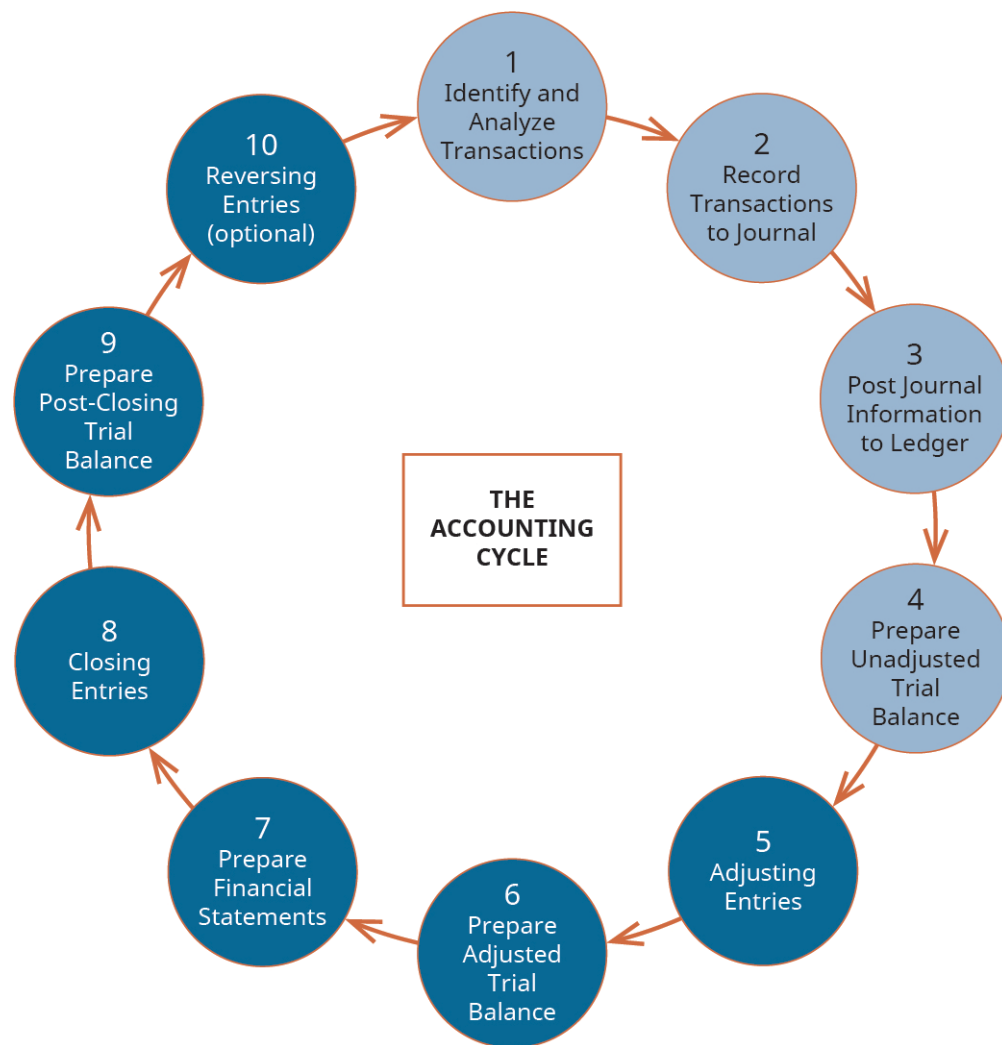


Figure 3.5 The Accounting Cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

As you can see, the cycle begins with identifying and analyzing transactions, and culminates in reversing entries (which we do not cover in this textbook). The entire cycle is meant to keep financial data organized and easily accessible to both internal and external users of information. In this chapter, we focus on the first four steps in the accounting cycle: identify and analyze transactions, record transactions to a journal, post journal information to a ledger, and prepare an unadjusted trial balance.

In [The Adjustment Process](#) we review steps 5, 6, and 7 in the accounting cycle: record adjusting entries, prepare an adjusted trial balance, and prepare financial statements. In [Completing the Accounting Cycle](#), we review steps 8 and 9: closing entries and prepare a post-closing trial balance. As stated previously, we do not cover reversing entries.

ETHICAL CONSIDERATIONS

Turning Hacked Gift Card Accounts into Cash

Gift cards are a great way for a company to presell its products and to create cash flow. One of the problems with gift cards is that fraudsters are using the retailer's weak internal controls to defraud the retailer's customers. A fraudster can hack into autoloading gift cards and drain a customer's bank account by buying new, physical gift cards through the autoloading gift card account. This is a real problem, and an internal control to reduce this type of fraud is to use a double verification system for the transfer of money from a bank account to reloadable gift card account. Accountants can help their organization limit gift card fraud by reviewing their company's internal controls over the gift card process.

A simple explanation of this fraud is that a fraudster will gain access to an individual's email account through phishing or by other means, such as a fraudster putting a key logger on a public computer or in a corrupted public Wi-Fi. The individual uses the same password for the reloadable gift card as his or her email account, and the fraudster will see emails about the gift card. The fraudster contacts the retailer posing as the individual, and the retailer creates an in-store gift card redemption code, and the fraudster or his or her accomplice will go to the store posing as the individual and buy physical gift cards with the redemption code. The customer's bank account will be drained, and the customer will be upset. In another gift card fraud, the individual's credit card is stolen and used to buy physical gift cards from a retailer. This type of fraud causes problems for the retailer, for the retailer's reputation is damaged through the implementation of poor internal controls.

Does the fraudster use the fraudulently acquired gift cards? No, there is an entire market for selling gift cards on [Craigslist](#), just go look and see how easy it is to buy discounted gift cards on [Craigslist](#). Also, there are companies such as [cardcash.com](#) and [cardhub.com](#) that buy and resell gift cards. The fraudster just sells the gift cards, and the retailer has no idea it is redeeming fraudulently acquired gift cards. Through the implementation of proper internal controls, the accountant can help limit this fraud and protect his or her employer's reputation.

First Four Steps in the Accounting Cycle

The first four steps in the accounting cycle are (1) identify and analyze transactions, (2) record transactions to a journal, (3) post journal information to a ledger, and (4) prepare an unadjusted trial balance. We begin by introducing the steps and their related documentation.

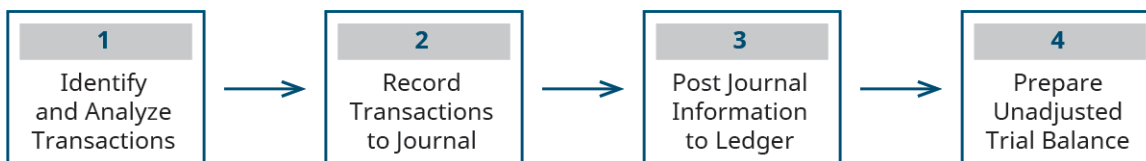


Figure 3.6 Accounting Cycle. The first four steps in the accounting cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

These first four steps set the foundation for the recording process.

Step 1. Identifying and analyzing transactions is the first step in the process. This takes information from

original sources or activities and translates that information into usable financial data. An **original source** is a traceable record of information that contributes to the creation of a business transaction. For example, a sales invoice is considered an original source. Activities would include paying an employee, selling products, providing a service, collecting cash, borrowing money, and issuing stock to company owners. Once the original source has been identified, the company will analyze the information to see how it influences financial records.

Let's say that Mark Summers of Supreme Cleaners (from [Why It Matters](#)) provides cleaning services to a customer. He generates an invoice for \$200, the amount the customer owes, so he can be paid for the service. This sales receipt contains information such as how much the customer owes, payment terms, and dates. This sales receipt is an original source containing financial information that creates a business transaction for the company.

Step 2. The second step in the process is recording transactions to a journal. This takes analyzed data from step 1 and organizes it into a comprehensive record of every company transaction. A **transaction** is a business activity or event that has an effect on financial information presented on financial statements. The information to record a transaction comes from an original source. A **journal** (also known as the book of original entry or general journal) is a record of all transactions.

For example, in the previous transaction, Supreme Cleaners had the invoice for \$200. Mark Summers needs to record this \$200 in his financial records. He needs to choose what accounts represent this transaction, whether or not this transaction will increase or decreases the accounts, and how that impacts the accounting equation before he can record the transaction in his journal. He needs to do this process for every transaction occurring during the period.

[Figure 3.7](#) includes information such as the date of the transaction, the accounts required in the journal entry, and columns for debits and credits.

GENERAL JOURNAL			
Date	Account Title	Debit	Credit

Figure 3.7 General Journal. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Step 3. The third step in the process is posting journal information to a ledger. **Posting** takes all transactions from the journal during a period and moves the information to a general ledger, or ledger. As you've learned, account balances can be represented visually in the form of T-accounts.

Returning to Supreme Cleaners, Mark identified the accounts needed to represent the \$200 sale and recorded them in his journal. He will then take the account information and move it to his general ledger. All of the accounts he used during the period will be shown on the general ledger, not only those accounts impacted by the \$200 sale.

Accounts Receivable		Cleaning Revenue	
Debit	Credit	Debit	Credit
Jan. 1	\$200		Jan. 1
			\$200
Bal \$200		Bal \$200	

Figure 3.8 General Ledger in T-Account Form. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Step 4. The fourth step in the process is to prepare an unadjusted trial balance. This step takes information from the general ledger and transfers it onto a document showing all account balances, and ensuring that debits and credits for the period balance (debit and credit totals are equal).

Mark Summers from Supreme Cleaners needs to organize all of his accounts and their balances, including the \$200 sale, onto a trial balance. He also needs to ensure his debits and credits are balanced at the culmination of this step.

SUPREME CLEAN Trial Balance April 30, 2018		
Account Title	Debit	Credit
Cash	XXX	
Accounts receivable	XXX	
Office supplies	XXX	
Prepaid insurance	XXX	
Equipment	XXX	
Accounts payable		XXX
Unearned cleaning revenue		XXX
Common stock		XXX
Dividends	XXX	
Cleaning revenue		XXX
Gas expense	XXX	
Advertising expense	XXX	
	<u>XXX</u>	<u>XXX</u>

Figure 3.9 Unadjusted Trial Balance. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

It is important to note that recording the entire process requires a strong attention to detail. Any mistakes early on in the process can lead to incorrect reporting information on financial statements. If this occurs, accountants may have to go all the way back to the beginning of the process to find their error. Make sure that as you complete each step, you are careful and really take the time to understand how to record information and why you are recording it. In the next section, you will learn how the accounting equation is used to analyze transactions.

CONCEPTS IN PRACTICE

Forensic Accounting

Ever dream about working for the Federal Bureau of Investigation (FBI)? As a forensic accountant, that dream might just be possible. A forensic accountant investigates financial crimes, such as tax evasion, insider trading, and embezzlement, among other things. Forensic accountants review financial records looking for clues to bring about charges against potential criminals. They consider every part of the accounting cycle, including original source documents, looking through journal entries, general ledgers, and financial statements. They may even be asked to testify to their findings in a court of law.

To be a successful forensic accountant, one must be detailed, organized, and naturally inquisitive. This position will need to retrace the steps a suspect may have taken to cover up fraudulent financial activities. Understanding how a company operates can help identify fraudulent activities that veer from the company's position. Some of the best forensic accountants have put away major criminals such as Al Capone, Bernie Madoff, Ken Lay, and Ivan Boesky.

LINK TO LEARNING

A tool that can be helpful to businesses looking for an easier way to view their accounting processes is to have drillable financial statements. This feature can be found in several software systems, allowing companies to go through the accounting cycle from transaction entry to financial statement construction. Read this [Journal of Accountancy column on drillable financial statements \(https://openstax.org/l/50DrillFinState\)](https://openstax.org/l/50DrillFinState) to learn more.

3.4 Analyze Business Transactions Using the Accounting Equation and Show the Impact of Business Transactions on Financial Statements

You gained a basic understanding of both the basic and expanded accounting equations, and looked at examples of assets, liabilities, and stockholder's equity in [Define and Examine the Expanded Accounting Equation and Its Relationship to Analyzing Transactions](#). Now, we can consider some of the transactions a business may encounter. We can review how each transaction would affect the basic accounting equation and the corresponding financial statements.

As discussed in [Define and Examine the Initial Steps in the Accounting Cycle](#), the first step in the accounting cycle is to identify and analyze transactions. Each original source must be evaluated for financial implications. Meaning, will the information contained on this original source affect the financial statements? If the answer is yes, the company will then analyze the information for *how* it affects the financial statements. For example, if a company receives a cash payment from a customer, the company needs to know how to record the cash payment in a meaningful way to keep its financial statements up to date.

YOUR TURN

Monetary Value of Transactions

You are the accountant for a small computer programming company. You must record the following transactions. What values do you think you will use for each transaction?

- A. The company purchased a secondhand van to be used to travel to customers. The sellers told you they believe it is worth \$12,500 but agreed to sell it to your company for \$11,000. You believe the company got a really good deal because the van has a \$13,000 Blue Book value.
- B. Your company purchased its office building five years ago for \$175,000. Values of real estate have been rising quickly over the last five years, and a realtor told you the company could easily sell it for \$250,000 today. Since the building is now worth \$250,000, you are contemplating whether you should increase its value on the books to reflect this estimated current market value.
- C. Your company has performed a task for a customer. The customer agreed to a minimum price of \$2,350 for the work, but if the customer has absolutely no issues with the programming for the first month, the customer will pay you \$2,500 (which includes a bonus for work well done). The owner of the company is almost 100% sure she will receive \$2,500 for the job done. You have to record the revenue earned and need to decide how much should be recorded.
- D. The owner of the company believes the most valuable asset for his company is the employees. The service the company provides depends on having intelligent, hardworking, dependable employees who believe they need to deliver exactly what the customer wants in a reasonable amount of time. Without the employees, the company would not be so successful. The owner wants to know if she can include the value of her employees on the balance sheet as an asset.

Solution

- A. The van must be recorded on the books at \$11,000 per the cost principle. That is the price that was agreed to between a willing buyer and seller.
- B. The cost principle states that you must record an asset on the books for the price you bought it for and then leave it on the books at that value unless there is a specific rule to the contrary. The company purchased the building for \$175,000. It must stay on the books at \$175,000. Companies are not allowed to increase the value of an asset on their books just because they believe it is worth more.
- C. You must record the revenue at \$2,350 per the rules of conservatism. We do not want to record revenue at \$2,500 when we are not absolutely 100% sure that is what we will earn. Recording it at \$2,500 might mislead our statement users to think we have earned more revenue than we really have.
- D. Even though the employees are a wonderful asset for the company, they cannot be included on the balance sheet as an asset. There is no way to assign a monetary value in US dollars to our employees. Therefore, we cannot include them in our assets.

Reviewing and Analyzing Transactions

Let us assume our business is a service-based company. We use Lynn Sanders' small printing company, Printing Plus, as our example. Please notice that since Printing Plus is a corporation, we are using the Common Stock account, instead of Owner's Equity. The following are several transactions from this business's current

month:

1. Issues \$20,000 shares of common stock for cash.
2. Purchases equipment on account for \$3,500, payment due within the month.
3. Receives \$4,000 cash in advance from a customer for services not yet rendered.
4. Provides \$5,500 in services to a customer who asks to be billed for the services.
5. Pays a \$300 utility bill with cash.
6. Distributed \$100 cash in dividends to stockholders.

We now analyze each of these transactions, paying attention to how they impact the accounting equation and corresponding financial statements.

Transaction 1: Issues \$20,000 shares of common stock for cash.

Assets	=	Liabilities	+	Equity
Cash +\$20,000				Common Stock +\$20,000

Analysis: Looking at the accounting equation, we know cash is an asset and common stock is stockholder's equity. When a company collects cash, this will increase assets because cash is coming into the business. When a company issues common stock, this will increase a stockholder's equity because he or she is receiving investments from owners.

Remember that the accounting equation must remain balanced, and assets need to equal liabilities plus equity. On the asset side of the equation, we show an increase of \$20,000. On the liabilities and equity side of the equation, there is also an increase of \$20,000, keeping the equation balanced. Changes to assets, specifically cash, will increase assets on the balance sheet and increase cash on the statement of cash flows. Changes to stockholder's equity, specifically common stock, will increase stockholder's equity on the balance sheet.

Transaction 2: Purchases equipment on account for \$3,500, payment due within the month.

Assets	=	Liabilities	+	Equity
Equipment +\$3,500		Accounts Payable +\$3,500		

Analysis: We know that the company purchased equipment, which is an asset. We also know that the company purchased the equipment on account, meaning it did not pay for the equipment immediately and asked for payment to be billed instead and paid later. Since the company owes money and has not yet paid, this is a liability, specifically labeled as *accounts payable*. There is an increase to assets because the company has equipment it did not have before. There is also an increase to liabilities because the company now owes money. The more money the company owes, the more that liability will increase.

The accounting equation remains balanced because there is a \$3,500 increase on the asset side, and a \$3,500 increase on the liability and equity side. This change to assets will increase assets on the balance sheet. The change to liabilities will increase liabilities on the balance sheet.

Transaction 3: Receives \$4,000 cash in advance from a customer for services not yet rendered.

Assets	=	Liabilities	+	Equity
Cash +\$4,000		Unearned Revenue +\$4,000		

Analysis: We know that the company collected cash, which is an asset. This collection of \$4,000 increases assets because money is coming into the business.

The company has yet to provide the service. According to the revenue recognition principle, the company cannot recognize that revenue until it provides the service. Therefore, the company has a liability to the customer to provide the service and must record the liability as unearned revenue. The liability of \$4,000 worth of services increases because the company has more unearned revenue than previously.

The equation remains balanced, as assets and liabilities increase. The balance sheet would experience an increase in assets and an increase in liabilities.

Transaction 4: Provides \$5,500 in services to a customer who asks to be billed for the services.

Assets	=	Liabilities	+	Equity
Accounts Receivable +\$5,500				Revenue +\$5,500

Analysis: The customer asked to be billed for the service, meaning the customer did not pay with cash immediately. The customer owes money and has not yet paid, signaling an accounts receivable. Accounts receivable is an asset that is increasing in this case. This customer obligation of \$5,500 adds to the balance in accounts receivable.

The company did provide the services. As a result, the revenue recognition principle requires recognition as revenue, which increases equity for \$5,500. The increase to assets would be reflected on the balance sheet. The increase to equity would affect three statements. The income statement would see an increase to revenues, changing net income (loss). Net income (loss) is computed into retained earnings on the statement of retained earnings. This change to retained earnings is shown on the balance sheet under stockholder's equity.

Transaction 5: Pays a \$300 utility bill with cash.

Assets	=	Liabilities	+	Equity
Cash -\$300				Expense -\$300

Analysis: The company paid with cash, an asset. Assets are decreasing by \$300 since cash was used to pay for this utility bill. The company no longer has that money.

Utility payments are generated from bills for services that were used and paid for within the accounting period, thus recognized as an expense. The expense decreases equity by \$300. The decrease to assets, specifically cash, affects the balance sheet and statement of cash flows. The decrease to equity as a result of the expense affects three statements. The income statement would see a change to expenses, changing net income (loss). Net income (loss) is computed into retained earnings on the statement of retained earnings. This change to retained earnings is shown on the balance sheet under stockholder's equity.

Transaction 6: Distributed \$100 cash in dividends to stockholders.

Assets	=	Liabilities	+	Equity
Cash -\$100				Dividends -\$100

Analysis: The company paid the distribution with cash, an asset. Assets decrease by \$100 as a result. Dividends affect equity and, in this case, decrease equity by \$100. The decrease to assets, specifically cash,

affects the balance sheet and statement of cash flows. The decrease to equity because of the dividend payout affects the statement of retained earnings by reducing ending retained earnings, and the balance sheet by reducing stockholder's equity.

Let's summarize the transactions and make sure the accounting equation has remained balanced. Shown are each of the transactions.

	Assets			=	Liabilities			+	Equity						
	Cash	Accounts Receivable	Equipment		Accounts Payable	Unearned Revenue	Common Stock		Dividends	Revenues	Expenses				
1	+20,000						+20,000								
2			+3,500		+3,500										
3	+4,000					+4,000									
4		+5,500								+5,500					
5	-300										-300				
6	-100								-100						
Total	23,600	+	5,500	+	3,500	+	4,000	+	20,000	-	100	+	5,500	-	300

\$32,600

Balanced

\$32,600

As you can see, assets total \$32,600, while liabilities added to equity also equal \$32,600. Our accounting equation remains balanced. In [Use Journal Entries to Record Transactions and Post to T-Accounts](#), we add other elements to the accounting equation and expand the equation to include individual revenue and expense accounts.

YOUR TURN

Debbie's Dairy Farm

Debbie's Dairy Farm had the following transactions:

- Debbie ordered shelving worth \$750.
- Debbie's selling price on a gallon of milk is \$3.00. She finds out that most local stores are charging \$3.50. Based on this information, she decides to increase her price to \$3.25. She has an employee put a new price sticker on each gallon.
- A customer buys a gallon of milk paying cash.
- The shelving is delivered with an invoice for \$750.

Which events will be recorded in the accounting system?

Solution

- Debbie did not yet receive the shelving—it has only been ordered. As of now there is no new asset owned by the company. Since the shelving has not yet been delivered, Debbie does not owe any money to the other company. Debbie will not record the transaction.
- Changing prices does not have an impact on the company at the time the price is changed. All that

happened was that a new price sticker was placed on the milk. Debbie still has all the milk and has not received any money. Debbie will not record the transaction.

- C. Debbie now has a transaction to record. She has received cash and the customer has taken some of her inventory of milk. She has an increase in one asset (cash) and a decrease in another asset (inventory.) She also has earned revenue.
- D. Debbie has taken possession of the shelving and is the legal owner. She also has an increase in her liabilities as she accepted delivery of the shelving but has not paid for it. Debbie will record this transaction.

3.5 Use Journal Entries to Record Transactions and Post to T-Accounts

When we introduced debits and credits, you learned about the usefulness of T-accounts as a graphic representation of any account in the general ledger. But before transactions are posted to the T-accounts, they are first recorded using special forms known as *journals*.

Journals

Accountants use special forms called *journals* to keep track of their business transactions. A journal is the first place information is entered into the accounting system. A journal is often referred to as the **book of original entry** because it is the place the information originally enters into the system. A journal keeps a historical account of all recordable transactions with which the company has engaged. In other words, a journal is similar to a diary for a business. When you enter information into a journal, we say you are **journalizing** the entry. Journaling the entry is the second step in the accounting cycle. Here is a picture of a journal.

JOURNAL			
Date	Account	Debit	Credit

You can see that a journal has columns labeled debit and credit. The debit is on the left side, and the credit is on the right. Let's look at how we use a journal.

When filling in a journal, there are some rules you need to follow to improve journal entry organization.

Formatting When Recording Journal Entries

- Include a date of when the transaction occurred.
- The debit account title(s) always come first and on the left.
- The credit account title(s) always come after all debit titles are entered, and on the right.
- The titles of the credit accounts will be indented below the debit accounts.
- You will have at least one debit (possibly more).
- You will always have at least one credit (possibly more).
- The dollar value of the debits must equal the dollar value of the credits or else the equation will go out of balance.
- You will write a short description after each journal entry.
- Skip a space after the description before starting the next journal entry.

An example journal entry format is as follows. It is not taken from previous examples but is intended to stand alone.

JOURNAL			
Date	Description	Debit	Credit
Apr. 1, 2018	Cash Common Stock <i>Received cash in exchange for common stock</i>	5,000	5,000

Note that this example has only one debit account and one credit account, which is considered a **simple entry**. A **compound entry** is when there is more than one account listed under the debit and/or credit column of a journal entry (as seen in the following).

JOURNAL			
Date	Account	Debit	Credit
Apr. 1, 2018	Cash Supplies Common Stock <i>Received cash and supplies in exchange for common stock</i>	3,000 2,000	5,000

Notice that for this entry, the rules for recording journal entries have been followed. There is a date of April 1, 2018, the debit account titles are listed first with Cash and Supplies, the credit account title of Common Stock is indented after the debit account titles, there are at least one debit and one credit, the debit amounts equal the credit amount, and there is a short description of the transaction.

Let's now look at a few transactions from Printing Plus and record their journal entries.

Recording Transactions

We now return to our company example of Printing Plus, Lynn Sanders' printing service company. We will analyze and record each of the transactions for her business and discuss how this impacts the financial statements. Some of the listed transactions have been ones we have seen throughout this chapter. More detail for each of these transactions is provided, along with a few new transactions.

1. On January 3, 2019, issues \$20,000 shares of common stock for cash.
2. On January 5, 2019, purchases equipment on account for \$3,500, payment due within the month.
3. On January 9, 2019, receives \$4,000 cash in advance from a customer for services not yet rendered.
4. On January 10, 2019, provides \$5,500 in services to a customer who asks to be billed for the services.
5. On January 12, 2019, pays a \$300 utility bill with cash.
6. On January 14, 2019, distributed \$100 cash in dividends to stockholders.
7. On January 17, 2019, receives \$2,800 cash from a customer for services rendered.
8. On January 18, 2019, paid in full, with cash, for the equipment purchase on January 5.
9. On January 20, 2019, paid \$3,600 cash in salaries expense to employees.
10. On January 23, 2019, received cash payment in full from the customer on the January 10 transaction.
11. On January 27, 2019, provides \$1,200 in services to a customer who asks to be billed for the services.
12. On January 30, 2019, purchases supplies on account for \$500, payment due within three months.

Transaction 1: On January 3, 2019, issues \$20,000 shares of common stock for cash.

Analysis:

- This is a transaction that needs to be recorded, as Printing Plus has received money, and the stockholders have invested in the firm.
- Printing Plus now has more cash. Cash is an asset, which in this case is increasing. Cash increases on the debit side.
- When the company issues stock, stockholders purchase common stock, yielding a higher common stock figure than before issuance. The common stock account is increasing and affects equity. Looking at the expanded accounting equation, we see that Common Stock increases on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 3, 2019	Cash Common Stock <i>To recognize issuance of common stock</i>	20,000	20,000

Impact on the financial statements: Both of these accounts are balance sheet accounts. You will see total assets increase and total stockholders' equity will also increase, both by \$20,000. With both totals increasing by \$20,000, the accounting equation, and therefore our balance sheet, will be in balance. There is no effect on the income statement from this transaction as there were no revenues or expenses recorded.

Assets	=	Liabilities	+	Stockholders' Equity
+\$20,000	=	+\$0	+	+\$20,000
\$20,000	=	\$0	+	\$20,000

Transaction 2: On January 5, 2019, purchases equipment on account for \$3,500, payment due within the month.

Analysis:

- In this case, equipment is an asset that is increasing. It increases because Printing Plus now has more equipment than it did before. Assets increase on the debit side; therefore, the Equipment account would show a \$3,500 debit.
- The company did not pay for the equipment immediately. Lynn asked to be sent a bill for payment at a future date. This creates a liability for Printing Plus, who owes the supplier money for the equipment. Accounts Payable is used to recognize this liability. This liability is increasing, as the company now owes money to the supplier. A liability account increases on the credit side; therefore, Accounts Payable will increase on the credit side in the amount of \$3,500.

JOURNAL			
Date	Account	Debit	Credit
Jan. 5, 2019	Equipment Accounts Payable <i>To recognize purchase of equipment on account</i>	3,500	3,500

Impact on the financial statements: Since both accounts in the entry are balance sheet accounts, you will see no effect on the income statement.

Assets	=	Liabilities	+	Stockholders' Equity
+\$3,500	=	+\$3,500	+	0
\$3,500	=	\$3,500	+	0

Transaction 3: On January 9, 2019, receives \$4,000 cash in advance from a customer for services not yet rendered.

Analysis:

- Cash was received, thus increasing the Cash account. Cash is an asset that increases on the debit side.
- Printing Plus has not yet provided the service, meaning it cannot recognize the revenue as earned. The company has a liability to the customer until it provides the service. The Unearned Revenue account would be used to recognize this liability. This is a liability the company did not have before, thus increasing this account. Liabilities increase on the credit side; thus, Unearned Revenue will recognize the \$4,000 on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 9, 2019	Cash Unearned Revenue <i>To recognize receipt of customer advanced payment for services yet to be rendered</i>	4,000	4,000

Impact on the financial statements: Since both accounts in the entry are balance sheet accounts, you will see no effect on the income statement.

Assets	=	Liabilities	+	Stockholders' Equity
+\$4,000	=	+\$4,000	+	0
\$4,000	=	\$4,000	+	0

Transaction 4: On January 10, 2019, provides \$5,500 in services to a customer who asks to be billed for the services.

Analysis:

- The company provided service to the client; therefore, the company may recognize the revenue as earned (revenue recognition principle), which increases revenue. Service Revenue is a revenue account affecting equity. Revenue accounts increase on the credit side; thus, Service Revenue will show an increase of \$5,500 on the credit side.
- The customer did not immediately pay for the services and owes Printing Plus payment. This money will be received in the future, increasing Accounts Receivable. Accounts Receivable is an asset account. Asset accounts increase on the debit side. Therefore, Accounts Receivable will increase for \$5,500 on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 10, 2019	Accounts Receivable Service Revenue <i>To recognize revenue earned, billed customer</i>	5,500	5,500

Impact on the financial statements: You have revenue of \$5,500. Revenue is reported on your income statement. The more revenue you have, the more net income (earnings) you will have. The more earnings you have, the more retained earnings you will keep. Retained earnings is a stockholders' equity account, so total equity will increase \$5,500. Accounts receivable is going up so total assets will increase by \$5,500. The accounting equation, and therefore the balance sheet, remain in balance.

Assets	=	Liabilities	+	Stockholders' Equity
+\$5,500	=	0	+	+\$5,500
\$5,500	=	0	+	\$5,500

Transaction 5: On January 12, 2019, pays a \$300 utility bill with cash.

Analysis:

- Cash was used to pay the utility bill, which means cash is decreasing. Cash is an asset that decreases on the credit side.
- Paying a utility bill creates an expense for the company. Utility Expense increases, and does so on the debit side of the accounting equation.

JOURNAL			
Date	Account	Debit	Credit
Jan. 12, 2019	Utility Expense Cash <i>Paid utility bill with cash</i>	300	300

Impact on the financial statements: You have an expense of \$300. Expenses are reported on your income statement. More expenses lead to a decrease in net income (earnings). The fewer earnings you have, the fewer retained earnings you will end up with. Retained earnings is a stockholders' equity account, so total equity will decrease by \$300. Cash is decreasing, so total assets will decrease by \$300, impacting the balance sheet.

Assets	=	Liabilities	+	Stockholders' Equity
-\$300	=	0	+	-\$300
\$300	=	0	+	\$300

Transaction 6: On January 14, 2019, distributed \$100 cash in dividends to stockholders.

Analysis:

- Cash was used to pay the dividends, which means cash is decreasing. Cash is an asset that decreases on the credit side.
- Dividends distribution occurred, which increases the Dividends account. Dividends is a part of stockholder's equity and is recorded on the debit side. This debit entry has the effect of reducing stockholder's equity.

JOURNAL			
Date	Account	Debit	Credit
Jan.14, 2019	Dividends Cash <i>Paid dividends with cash</i>	100	100

Impact on the financial statements: You have dividends of \$100. An increase in dividends leads to a decrease in stockholders' equity (retained earnings). Cash is decreasing, so total assets will decrease by \$100, impacting the balance sheet.

Assets	=	Liabilities	+	Stockholders' Equity
-\$100	=	0	+	-\$100
\$100	=	0	+	\$100

Transaction 7: On January 17, 2019, receives \$2,800 cash from a customer for services rendered.

Analysis:

- The customer used cash as the payment method, thus increasing the amount in the Cash account. Cash is an asset that is increasing, and it does so on the debit side.
- Printing Plus provided the services, which means the company can recognize revenue as earned in the Service Revenue account. Service Revenue increases equity; therefore, Service Revenue increases on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 17, 2019	Cash Service Revenue <i>Collected cash for services rendered</i>	2,800	2,800

Impact on the financial statements: Revenue is reported on the income statement. More revenue will increase net income (earnings), thus increasing retained earnings. Retained earnings is a stockholders' equity account, so total equity will increase \$2,800. Cash is increasing, which increases total assets on the balance sheet.

Assets	=	Liabilities	+	Stockholders' Equity
+\$2,800	=	0	+	+\$2,800
\$2,800	=	0	+	\$2,800

Transaction 8: On January 18, 2019, paid in full, with cash, for the equipment purchase on January 5.

Analysis:

- Cash is decreasing because it was used to pay for the outstanding liability created on January 5. Cash is an asset and will decrease on the credit side.
- Accounts Payable recognized the liability the company had to the supplier to pay for the equipment. Since the company is now paying off the debt it owes, this will decrease Accounts Payable. Liabilities decrease on the debit side; therefore, Accounts Payable will decrease on the debit side by \$3,500.

JOURNAL			
Date	Account	Debit	Credit
Jan. 18, 2019	Accounts Payable Cash <i>Paid liability for equipment in full</i>	3,500	3,500

Impact on the financial statements: Since both accounts in the entry are balance sheet accounts, you will see no effect on the income statement.

Assets	=	Liabilities	+	Stockholders' Equity
-\$3,500	=	-\$3,500	+	0
\$3,500	=	\$3,500	+	0

Transaction 9: On January 20, 2019, paid \$3,600 cash in salaries expense to employees.

Analysis:

- Cash was used to pay for salaries, which decreases the Cash account. Cash is an asset that decreases on the credit side.
- Salaries are an expense to the business for employee work. This will increase Salaries Expense, affecting equity. Expenses increase on the debit side; thus, Salaries Expense will increase on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 20, 2019	Salaries Expense Cash <i>Paid employee salaries</i>	3,600	3,600

Impact on the financial statements: You have an expense of \$3,600. Expenses are reported on the income statement. More expenses lead to a decrease in net income (earnings). The fewer earnings you have, the fewer retained earnings you will end up with. Retained earnings is a stockholders' equity account, so total equity will decrease by \$3,600. Cash is decreasing, so total assets will decrease by \$3,600, impacting the balance sheet.

Assets	=	Liabilities	+	Stockholders' Equity
-\$3,600	=	0	+	-\$3,600
\$3,600	=	0	+	\$3,600

Transaction 10: On January 23, 2019, received cash payment in full from the customer on the January 10 transaction.

Analysis:

- Cash was received, thus increasing the Cash account. Cash is an asset, and assets increase on the debit side.
- Accounts Receivable was originally used to recognize the future customer payment; now that the customer has paid in full, Accounts Receivable will decrease. Accounts Receivable is an asset, and assets decrease on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 23, 2019	Cash Accounts Receivable <i>Received customer payment from Jan. 10</i>	5,500	5,500

Impact on the financial statements: In this transaction, there was an increase to one asset (Cash) and a decrease to another asset (Accounts Receivable). This means total assets change by \$0, because the increase and decrease to assets in the same amount cancel each other out. There are no changes to liabilities or stockholders' equity, so the equation is still in balance. Since there are no revenues or expenses affected, there is no effect on the income statement.

Assets	=	Liabilities	+	Stockholders' Equity
+\$5,500	=	0	+	0
-\$5,500				0
\$0	=	0	+	

Transaction 11: On January 27, 2019, provides \$1,200 in services to a customer who asks to be billed for the services.

Analysis:

- The customer does not pay immediately for the services but is expected to pay at a future date. This creates an Accounts Receivable for Printing Plus. The customer owes the money, which increases Accounts Receivable. Accounts Receivable is an asset, and assets increase on the debit side.
- Printing Plus provided the service, thus earning revenue. Service Revenue would increase on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 27, 2019	Accounts Receivable Service Revenue <i>Billed customer for services rendered</i>	1,200	1,200

Impact on the financial statements: Revenue is reported on the income statement. More revenue will increase net income (earnings), thus increasing retained earnings. Retained earnings is a stockholders' equity account, so total equity will increase \$1,200. Cash is increasing, which increases total assets on the balance sheet.

Assets	=	Liabilities	+	Stockholders' Equity
+\$1,200	=	0	+	+\$1,200
\$1,200	=	0	+	\$1,200

Transaction 12: On January 30, 2019, purchases supplies on account for \$500, payment due within three months.

Analysis:

- The company purchased supplies, which are assets to the business until used. Supplies is increasing, because the company has more supplies than it did before. Supplies is an asset that is increasing on the

debit side.

- Printing Plus did not pay immediately for the supplies and asked to be billed for the supplies, payable at a later date. This creates a liability for the company, Accounts Payable. This liability increases Accounts Payable; thus, Accounts Payable increases on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Jan. 30, 2019	Supplies Accounts Payable <i>Billed customer for services rendered</i>	500	500

Impact on the financial statements: There is an increase to a liability and an increase to assets. These accounts both impact the balance sheet but not the income statement.

Assets	=	Liabilities	+	Stockholders' Equity
+\$500	=	+\$500	+	0
\$500	=	\$500	+	0

The complete journal for these transactions is as follows:

JOURNAL			
Date	Account	Debit	Credit
Jan. 3, 2019	Cash Common Stock <i>Recognize issuance of common stock</i>	20,000	20,000
Jan. 5, 2019	Equipment Account Payable <i>Recognize purchase of equipment on account</i>	3,500	3,500
Jan. 9, 2019	Cash Unearned revenue <i>Received advanced payment for services yet to be rendered</i>	4,000	4,000
Jan. 10, 2019	Accounts receivable Service Revenue <i>Revenue earned, billed customer</i>	5,500	5,500
Jan. 12, 2019	Utility Expense Cash <i>Paid utility bill</i>	300	300
Jan. 14, 2019	Dividends Cash <i>Paid out dividends</i>	100	100
Jan. 17, 2019	Cash Service Revenue <i>Collected cash for services rendered</i>	2,800	2,800
Jan. 18, 2019	Accounts Payable Cash <i>Paid liability for equipment in full</i>	3,500	3,500
Jan. 20, 2019	Salaries Expense Cash <i>Paid employee salaries</i>	3,600	3,600
Jan. 23, 2019	Cash Accounts Receivable <i>Received customer payment from Jan. 10</i>	5,500	5,500
Jan. 27, 2019	Accounts Receivable Service Revenue <i>Billed customer for services rendered</i>	1,200	1,200
Jan. 30, 2019	Supplies Accounts Payable <i>Paid for supplies on account</i>	500	500

We now look at the next step in the accounting cycle, step 3: post journal information to the ledger.

CONTINUING APPLICATION AT WORK

Colfax Market

Colfax Market is a small corner grocery store that carries a variety of staple items such as meat, milk, eggs, bread, and so on. As a smaller grocery store, **Colfax** does not offer the variety of products found in a larger supermarket or chain. However, it records journal entries in a similar way.

Grocery stores of all sizes must purchase product and track inventory. While the number of entries might differ, the recording process does not. For example, **Colfax** might purchase food items in one large quantity at the beginning of each month, payable by the end of the month. Therefore, it might only have a few accounts payable and inventory journal entries each month. Larger grocery chains might have multiple deliveries a week, and multiple entries for purchases from a variety of vendors on their accounts payable weekly.

This similarity extends to other retailers, from clothing stores to sporting goods to hardware. No matter the size of a company and no matter the product a company sells, the fundamental accounting entries remain the same.

Posting to the General Ledger

Recall that the general ledger is a record of each account and its balance. Reviewing journal entries individually can be tedious and time consuming. The general ledger is helpful in that a company can easily extract account and balance information. Here is a small section of a general ledger.

GENERAL LEDGER					
Cash					Account No. 101
Date	Description	Ref.	Debit	Credit	Balance
2019					

You can see at the top is the name of the account “Cash,” as well as the assigned account number “101.”

Remember, all asset accounts will start with the number 1. The date of each transaction related to this account is included, a possible description of the transaction, and a reference number if available. There are debit and credit columns, storing the financial figures for each transaction, and a balance column that keeps a running total of the balance in the account after every transaction.

Let’s look at one of the journal entries from Printing Plus and fill in the corresponding ledgers.

JOURNAL			
Date	Account	Debit	Credit
Jan. 3, 2019	Cash Common stock <i>Received cash in exchange for common stock</i>	20,000	20,000

GENERAL LEDGER					
Cash					Account No. 101
Date	Description	Ref.	Debit	Credit	Balance
2019 Jan. 3	Cash for common stock		20,000		20,000
Common Stock					Account No. 301
Date	Description	Ref.	Debit	Credit	Balance
2019 Jan. 3	Cash for common stock			20,000	20,000

As you can see, there is one ledger account for Cash and another for Common Stock. Cash is labeled account number 101 because it is an asset account type. The date of January 3, 2019, is in the far left column, and a description of the transaction follows in the next column. Cash had a debit of \$20,000 in the journal entry, so \$20,000 is transferred to the general ledger in the debit column. The balance in this account is currently \$20,000, because no other transactions have affected this account yet.

Common Stock has the same date and description. Common Stock had a credit of \$20,000 in the journal entry, and that information is transferred to the general ledger account in the credit column. The balance at that time in the Common Stock ledger account is \$20,000.

Another key element to understanding the general ledger, and the third step in the accounting cycle, is how to calculate balances in ledger accounts.

LINK TO LEARNING

It is a good idea to familiarize yourself with the type of information companies report each year. Peruse [Best Buy's 2017 annual report \(https://openstax.org/l/50BestBuy2017\)](https://openstax.org/l/50BestBuy2017) to learn more about **Best Buy**. Take note of the company's balance sheet on page 53 of the report and the income statement on page 54. These reports have much more information than the financial statements we have shown you; however, if you read through them you may notice some familiar items.

Calculating Account Balances

When calculating balances in ledger accounts, one must take into consideration which side of the account increases and which side decreases. To find the account balance, you must find the difference between the

sum of all figures on the side that increases and the sum of all figures on the side that decreases.

For example, the Cash account is an asset. We know from the accounting equation that assets increase on the debit side and decrease on the credit side. If there was a debit of \$5,000 and a credit of \$3,000 in the Cash account, we would find the difference between the two, which is \$2,000 ($5,000 - 3,000$). The debit is the larger of the two sides (\$5,000 on the debit side as opposed to \$3,000 on the credit side), so the Cash account has a debit balance of \$2,000.

Another example is a liability account, such as Accounts Payable, which increases on the credit side and decreases on the debit side. If there were a \$4,000 credit and a \$2,500 debit, the difference between the two is \$1,500. The credit is the larger of the two sides (\$4,000 on the credit side as opposed to \$2,500 on the debit side), so the Accounts Payable account has a credit balance of \$1,500.

The following are selected journal entries from Printing Plus that affect the Cash account. We will use the Cash ledger account to calculate account balances.

JOURNAL			
Date	Account	Debit	Credit
Jan. 3, 2019	Cash Common Stock <i>Recognize issuance of common stock</i>	20,000	20,000
Jan. 9, 2019	Cash Unearned Revenue <i>Received advanced payment for services yet to be rendered</i>	4,000	4,000
Jan. 12, 2019	Utility Expense Cash <i>Paid utility bill</i>	300	300
Jan. 14, 2019	Dividends Cash <i>Paid out dividends</i>	100	100
Jan. 17, 2019	Cash Service Revenue <i>Collected cash for services rendered</i>	2,800	2,800
Jan. 18, 2019	Accounts Payable Cash <i>Paid liability for equipment in full</i>	3,500	3,500
Jan. 20, 2019	Salaries Expense Cash <i>Paid employee salaries</i>	3,600	3,600
Jan. 23, 2019	Cash Accounts Receivable <i>Received customer payment from Jan. 10</i>	5,500	5,500

The general ledger account for Cash would look like the following:

GENERAL LEDGER					
Cash					Account No. 101
Date	Item	Ref.	Debit	Credit	Balance
2019					
Jan. 3	Cash for common stock		20,000		20,000
Jan. 9	Payment from client		4,000		24,000
Jan. 12	Utility bill			300	23,700
Jan. 14	Dividends payment			100	23,600
Jan. 17	Cash for services		2,800		26,400
Jan. 18	Paid cash for equipment			3,500	22,900
Jan. 20	Paid employee salaries			3,600	19,300
Jan. 23	Customer payment		5,500		24,800

In the last column of the Cash ledger account is the running balance. This shows where the account stands after each transaction, as well as the final balance in the account. How do we know on which side, debit or credit, to input each of these balances? Let's consider the general ledger for Cash.

On January 3, there was a debit balance of \$20,000 in the Cash account. On January 9, a debit of \$4,000 was included. Since both are on the debit side, they will be added together to get a balance on \$24,000 (as is seen in the balance column on the January 9 row). On January 12, there was a credit of \$300 included in the Cash ledger account. Since this figure is on the credit side, this \$300 is subtracted from the previous balance of \$24,000 to get a new balance of \$23,700. The same process occurs for the rest of the entries in the ledger and their balances. The final balance in the account is \$24,800.

Checking to make sure the final balance figure is correct; one can review the figures in the debit and credit columns. In the debit column for this cash account, we see that the total is \$32,300 ($20,000 + 4,000 + 2,800 + 5,500$). The credit column totals \$7,500 ($300 + 100 + 3,500 + 3,600$). The difference between the debit and credit totals is \$24,800 ($32,300 - 7,500$). The balance in this Cash account is a debit of \$24,800. Having a debit balance in the Cash account is the normal balance for that account.

Posting to the T-Accounts

The third step in the accounting cycle is to post journal information to the ledger. To do this we can use a T-account format. A company will take information from its journal and post to this general ledger. Posting refers to the process of transferring data from the journal to the general ledger. It is important to understand that T-accounts are only used for illustrative purposes in a textbook, classroom, or business discussion. They are not official accounting forms. Companies will use ledgers for their official books, not T-accounts.

Let's look at the journal entries for Printing Plus and post each of those entries to their respective T-accounts.

The following are the journal entries recorded earlier for Printing Plus.

Transaction 1: On January 3, 2019, issues \$20,000 shares of common stock for cash.

JOURNAL			
Date	Account	Debit	Credit
Jan. 3, 2019	Cash Common Stock <i>To recognize issuance of common stock</i>	20,000	20,000

Cash	
Jan. 3	20,000
Bal. 20,000	

Common Stock	
	20,000 Jan. 3
	Bal. 20,000

In the journal entry, Cash has a debit of \$20,000. This is posted to the Cash T-account on the debit side (left side). Common Stock has a credit balance of \$20,000. This is posted to the Common Stock T-account on the credit side (right side).

Transaction 2: On January 5, 2019, purchases equipment on account for \$3,500, payment due within the month.

JOURNAL			
Date	Account	Debit	Credit
Jan. 5, 2019	Equipment Accounts Payable <i>To recognize purchase of equipment on account</i>	3,500	3,500

Equipment	
Jan. 5	3,500
Bal. 3,500	

Accounts Payable	
	3,500 Jan. 5
	Bal. 3,500

In the journal entry, Equipment has a debit of \$3,500. This is posted to the Equipment T-account on the debit side. Accounts Payable has a credit balance of \$3,500. This is posted to the Accounts Payable T-account on the credit side.

Transaction 3: On January 9, 2019, receives \$4,000 cash in advance from a customer for services not yet rendered.

JOURNAL			
Date	Account	Debit	Credit
Jan. 9, 2019	Cash Unearned Revenue <i>To recognize receipt of customer advanced payment for services yet to be rendered</i>	4,000	4,000

Cash	
Jan. 3 20,000	
Jan. 9 4,000	
Bal. 24,000	

Unearned Revenue	
	4,000 Jan. 9
	Bal. 4,000

In the journal entry, Cash has a debit of \$4,000. This is posted to the Cash T-account on the debit side. You will notice that the transaction from January 3 is listed already in this T-account. The next transaction figure of \$4,000 is added directly below the \$20,000 on the debit side. Unearned Revenue has a credit balance of \$4,000. This is posted to the Unearned Revenue T-account on the credit side.

Transaction 4: On January 10, 2019, provides \$5,500 in services to a customer who asks to be billed for the services.

JOURNAL			
Date	Account	Debit	Credit
Jan. 10, 2019	Accounts Receivable Service Revenue <i>To recognize revenue earned, billed customer</i>	5,500	5,500

Accounts Receivable	
Jan. 10 5,500	
Bal. 5,500	

Service Revenue	
	5,500 Jan. 10
	Bal. 5,500

In the journal entry, Accounts Receivable has a debit of \$5,500. This is posted to the Accounts Receivable T-account on the debit side. Service Revenue has a credit balance of \$5,500. This is posted to the Service Revenue T-account on the credit side.

Transaction 5: On January 12, 2019, pays a \$300 utility bill with cash.

JOURNAL			
Date	Account	Debit	Credit
Jan. 12, 2019	Utility Expense Cash <i>Paid utility bill with cash</i>	300	300

Utility Expense	
Jan. 12 300	
Bal. 300	

Cash	
Jan. 3 20,000	300 Jan. 12
Jan. 9 4,000	
Bal. 23,700	

In the journal entry, Utility Expense has a debit balance of \$300. This is posted to the Utility Expense T-account on the debit side. Cash has a credit of \$300. This is posted to the Cash T-account on the credit side. You will notice that the transactions from January 3 and January 9 are listed already in this T-account. The next transaction figure of \$300 is added on the credit side.

Transaction 6: On January 14, 2019, distributed \$100 cash in dividends to stockholders.

JOURNAL			
Date	Account	Debit	Credit
Jan. 14, 2019	Dividends Cash <i>Paid dividends with cash</i>	100	100

Dividends	
Jan. 14 100	
Bal. 100	

Cash	
Jan. 3 20,000	300 Jan. 12
Jan. 9 4,000	100 Jan. 14
Bal. 23,600	

In the journal entry, Dividends has a debit balance of \$100. This is posted to the Dividends T-account on the debit side. Cash has a credit of \$100. This is posted to the Cash T-account on the credit side. You will notice that the transactions from January 3, January 9, and January 12 are listed already in this T-account. The next transaction figure of \$100 is added directly below the January 12 record on the credit side.

Transaction 7: On January 17, 2019, receives \$2,800 cash from a customer for services rendered.

JOURNAL			
Date	Account	Debit	Credit
Jan. 17, 2019	Cash Service Revenue <i>Collected cash for services rendered</i>	2,800	2,800

Cash	
Jan. 3 20,000	300 Jan. 12
Jan. 9 4,000	100 Jan. 14
Jan. 17 2,800	
Bal. 26,400	

Service Revenue	
	5,500 Jan. 10
	2,800 Jan. 17
	Bal. 8,300

In the journal entry, Cash has a debit of \$2,800. This is posted to the Cash T-account on the debit side. You will notice that the transactions from January 3, January 9, January 12, and January 14 are listed already in this T-account. The next transaction figure of \$2,800 is added directly below the January 9 record on the debit side. Service Revenue has a credit balance of \$2,800. This too has a balance already from January 10. The new entry is recorded under the Jan 10 record, posted to the Service Revenue T-account on the credit side.

Transaction 8: On January 18, 2019, paid in full, with cash, for the equipment purchase on January 5.

JOURNAL			
Date	Account	Debit	Credit
Jan. 18, 2019	Accounts Payable Cash <i>Paid liability for equipment in full</i>	3,500	3,500

Cash	
Jan. 3 20,000	300 Jan. 12
Jan. 9 4,000	100 Jan. 14
Jan. 17 2,800	3,500 Jan. 18
Bal. 22,900	

Accounts Payable	
Jan. 18 3,500	3,500 Jan. 5
	Bal. 0

On this transaction, Cash has a credit of \$3,500. This is posted to the Cash T-account on the credit side beneath the January 14 transaction. Accounts Payable has a debit of \$3,500 (payment in full for the Jan. 5 purchase). You notice there is already a credit in Accounts Payable, and the new record is placed directly across from the January 5 record.

Transaction 9: On January 20, 2019, paid \$3,600 cash in salaries expense to employees.

JOURNAL			
Date	Account	Debit	Credit
Jan. 20, 2019	Salaries Expense Cash <i>Paid employee salaries</i>	3,600	3,600

Cash			
Jan. 3	20,000	300	Jan. 12
Jan. 9	4,000	100	Jan. 14
Jan. 17	2,800	3,500	Jan. 18
		3,600	Jan. 20
	Bal. 19,300		

Salaries Expense			
Jan. 20	3,600		
	Bal. 3,600		

On this transaction, Cash has a credit of \$3,600. This is posted to the Cash T-account on the credit side beneath the January 18 transaction. Salaries Expense has a debit of \$3,600. This is placed on the debit side of the Salaries Expense T-account.

Transaction 10: On January 23, 2019, received cash payment in full from the customer on the January 10 transaction.

JOURNAL			
Date	Account	Debit	Credit
Jan. 23, 2019	Cash Accounts Receivable <i>Received customer payment from Jan. 10</i>	5,500	5,500

Cash			
Jan. 3	20,500	300	Jan. 12
Jan. 9	4,000	100	Jan. 14
Jan. 17	2,800	3,500	Jan. 18
Jan. 23	5,500	3,600	Jan. 20
	Bal. 24,800		

Accounts Receivable			
Jan. 10	5,500	5,500	Jan. 23
	Bal. 0		

On this transaction, Cash has a debit of \$5,500. This is posted to the Cash T-account on the debit side beneath the January 17 transaction. Accounts Receivable has a credit of \$5,500 (from the Jan. 10 transaction). The record is placed on the credit side of the Accounts Receivable T-account across from the January 10 record.

Transaction 11: On January 27, 2019, provides \$1,200 in services to a customer who asks to be billed for the services.

JOURNAL			
Date	Account	Debit	Credit
Jan. 27, 2019	Accounts Receivable Service Revenue <i>Billed customer for services rendered</i>	1,200	1,200

Accounts Receivable	
Jan. 10 5,500	5,500 Jan. 23
Jan. 27 1,200	
Bal. 1,200	

Service Revenue	
	5,500 Jan. 10
	2,800 Jan. 17
	1,200 Jan. 27
	Bal. 9,500

On this transaction, Accounts Receivable has a debit of \$1,200. The record is placed on the debit side of the Accounts Receivable T-account underneath the January 10 record. Service Revenue has a credit of \$1,200. The record is placed on the credit side of the Service Revenue T-account underneath the January 17 record.

Transaction 12: On January 30, 2019, purchases supplies on account for \$500, payment due within three months.

JOURNAL			
Date	Account	Debit	Credit
Jan. 30, 2019	Supplies Accounts Payable <i>Purchased supplies on account</i>	500	500

Supplies	
Jan. 30 500	
Bal. 500	

Accounts Payable	
Jan. 18 3,500	3,500 Jan. 9
	500 Jan. 30
	Bal. 500

On this transaction, Supplies has a debit of \$500. This will go on the debit side of the Supplies T-account. Accounts Payable has a credit of \$500. You notice there are already figures in Accounts Payable, and the new record is placed directly underneath the January 5 record.

T-Accounts Summary

Once all journal entries have been posted to T-accounts, we can check to make sure the accounting equation remains balanced. A summary showing the T-accounts for Printing Plus is presented in [Figure 3.10](#).

Assets			=	Liabilities			+	Equity		
Cash				Accounts Payable				Common Stock		
Jan. 3	20,000	300	Jan. 12	Jan. 18	3,500	3,500	Jan. 5		20,000	Jan. 3
Jan. 9	4,000	100	Jan. 14			500	Jan. 30			
Jan. 17	2,800	3,500	Jan. 18							
Jan. 23	5,500	3,600	Jan. 20							
Bal. 24,800						Bal. 500			Bal. 20,000	
Accounts Receivable				Unearned Revenue				Dividends		
Jan. 10	5,500	5,500	Jan. 23			4,000	Jan. 9	Jan. 14	100	
Jan. 27	1,200									
Bal. 1,200						Bal. 4,000		Bal. 100		
Supplies								Service Revenue		
Jan. 30	500								5,500	Jan. 10
									2,800	Jan. 17
									1,200	Jan. 27
Bal. 500									Bal. 9,500	
Equipment								Salaries Expense		
Jan. 5	3,500							Jan. 20	3,600	
Bal. 3,500								Bal. 3,600		
								Utility Expense		
								Jan. 12	300	
								Bal. 300		

Figure 3.10 Summary of T-Accounts for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The sum on the assets side of the accounting equation equals \$30,000, found by adding together the final balances in each asset account (24,800 + 1,200 + 500 + 3,500). To find the total on the liabilities and equity side of the equation, we need to find the difference between debits and credits. Credits on the liabilities and equity side of the equation total \$34,000 (500 + 4,000 + 20,000 + 9,500). Debits on the liabilities and equity side of the equation total \$4,000 (100 + 3,600 + 300). The difference $\$34,000 - \$4,000 = \$30,000$. Thus, the equation remains balanced with \$30,000 on the asset side and \$30,000 on the liabilities and equity side. Now that we have the T-account information, and have confirmed the accounting equation remains balanced, we can create the unadjusted trial balance.

YOUR TURN

Journalizing Transactions

You have the following transactions the last few days of April.

Apr. 25	You stop by your uncle's gas station to refill both gas cans for your company, Watson's Landscaping. Your uncle adds the total of \$28 to your account.
Apr. 26	You record another week's revenue for the lawns mowed over the past week. You earned \$1,200. You received cash equal to 75% of your revenue.
Apr. 27	You pay your local newspaper \$35 to run an advertisement in this week's paper.
Apr. 29	You make a \$25 payment on account.

Table 3.3

- Prepare the necessary journal entries for these four transactions.
- Explain why you debited and credited the accounts you did.
- What will be the new balance in each account used in these entries?

Solution

JOURNAL			
Date	Account	Debit	Credit
Apr. 25, 2018	Gas expense Accounts payable <i>Purchased gas on account</i>	28	28
Apr. 26, 2018	Cash Accounts receivable Lawnmowing revenue <i>Earned \$1,200 revenue; received 75% in cash</i>	900 300	1,200
Apr. 27, 2018	Advertising expense Cash <i>Paid cash to run an ad in the newspaper</i>	35	35
Apr. 29, 2018	Accounts payable Cash <i>Made a payment on account</i>	25	25

April 25

- You have incurred more gas expense. This means you have an increase in the total amount of gas expense for April. Expenses go up with debit entries. Therefore, you will debit gas expense.

- You purchased the gas on account. This will increase your liabilities. Liabilities increase with credit entries. Credit accounts payable to increase the total in the account.

April 26

- You have received more cash from customers, so you want the total cash to increase. Cash is an asset, and assets increase with debit entries, so debit cash.
- You also have more money owed to you by your customers. You have performed the services, your customers owe you the money, and you will receive the money in the future. Debit accounts receivable as asset accounts increase with debits.
- You have mowed lawns and earned more revenue. You want the total of your revenue account to increase to reflect this additional revenue. Revenue accounts increase with credit entries, so credit lawn-mowing revenue.

April 27

- Advertising is an expense of doing business. You have incurred more expenses, so you want to increase an expense account. Expense accounts increase with debit entries. Debit advertising expense.
- You paid cash for the advertising. You have less cash, so credit the cash account. Cash is an asset, and asset account totals decrease with credits.

April 29

- You paid "on account." Remember that "on account" means a service was performed or an item was received without being paid for. The customer asked to be billed. You were the customer in this case. You made a purchase of gas on account earlier in the month, and at that time you increased accounts payable to show you had a liability to pay this amount sometime in the future. You are now paying down some of the money you owe on that account. Since you paid this money, you now have less of a liability so you want to see the liability account, accounts payable, decrease by the amount paid. Liability accounts decrease with debit entries.
- You paid, which means you gave cash (or wrote a check or electronically transferred) so you have less cash. To decrease the total cash, credit the account because asset accounts are reduced by recording credit entries.

YOUR TURN

Normal Account Balances

Calculate the balances in each of the following accounts. Do they all have the normal balance they should have? If not, which one? How do you know this?

GENERAL LEDGER					
Cash					Account No. 101
Date	Item	Ref.	Debit	Credit	Balance
2019					
			9,500		
			1,750	3,500	
			500	5,800	
				1,500	

GENERAL LEDGER					
Accounts Receivable					Account No. 111
Date	Item	Ref.	Debit	Credit	Balance
2019					
			4,500		
			3,650		
				4,250	
				3,500	
			825		

GENERAL LEDGER					
Accounts Payable					Account No. 201
Date	Item	Ref.	Debit	Credit	Balance
2019					
				1,500	
				875	
			500		
				325	
			650		

Solution

GENERAL LEDGER					
Cash					Account No. 101
Date	Item	Ref.	Debit	Credit	Balance
2019					
			9,500		9,500
				3,500	6,000
			1,750		7,750
				5,800	1,950
			500		2,450
				1,500	950

GENERAL LEDGER					
Accounts Receivable					Account No. 111
Date	Item	Ref.	Debit	Credit	Balance
2019					
			4,500		4,500
			3,650		8,150
				4,250	3,900
				3,500	400
			825		1,225

GENERAL LEDGER					
Accounts Payable					Account No. 201
Date	Item	Ref.	Debit	Credit	Balance
201X					
				1,500	1,500
				875	2,375
			500		1,875
				325	2,200
			650		1,550

THINK IT THROUGH

Gift Cards

Gift cards have become an important topic for managers of any company. Understanding who buys gift cards, why, and when can be important in business planning. Also, knowing when and how to determine that a gift card will not likely be redeemed will affect both the company's balance sheet (in the liabilities section) and the income statement (in the revenues section).

According to a 2017 holiday shopping report from the National Retail Federation, gift cards are the most-requested presents for the eleventh year in a row, with 61% of people surveyed saying they are at the top of their wish lists, according to the National Retail Federation.^[6] *CEB TowerGroup* projects that total gift card volume will reach \$160 billion by 2018.^[7]

How are all of these gift card sales affecting one of America's favorite specialty coffee companies, **Starbucks**?

In 2014 one in seven adults received a **Starbucks** gift card. On Christmas Eve alone \$2.5 million gift cards were sold. This is a rate of 1,700 cards per minute.^[8]

The following discussion about gift cards is taken from **Starbucks**'s 2016 annual report:

When an amount is loaded onto a stored value card we recognize a corresponding liability for the full amount loaded onto the card, which is recorded within stored value card liability on our consolidated balance sheets. When a stored value card is redeemed at a company-operated store or online, we recognize revenue by reducing the stored value card liability. When a stored value card is redeemed at a licensed store location, we reduce the corresponding stored value card liability and cash, which is reimbursed to the licensee. There are no expiration dates on our stored value cards, and in most markets, we do not charge service fees that cause a decrement to customer balances. While we will continue to honor all stored value cards presented for payment, management may determine the likelihood of redemption, based on historical experience, is deemed to be remote for certain cards due to long periods of inactivity. In these circumstances, unredeemed card balances may be recognized as breakage income. In fiscal 2016, 2015, and 2014, we recognized breakage income of \$60.5 million, \$39.3 million, and \$38.3 million, respectively.^[9]

As of October 1, 2017, **Starbucks** had a total of \$1,288,500,000 in stored value card liability.

3.6 Prepare a Trial Balance

Once all the monthly transactions have been analyzed, journalized, and posted on a continuous day-to-day basis over the accounting period (a month in our example), we are ready to start working on preparing a trial balance (unadjusted). Preparing an unadjusted trial balance is the fourth step in the accounting cycle. A **trial balance** is a list of all accounts in the general ledger that have nonzero balances. A trial balance is an important step in the accounting process, because it helps identify any computational errors throughout the first three steps in the cycle.

Note that for this step, we are considering our trial balance to be unadjusted. The **unadjusted trial balance** in this section includes accounts before they have been adjusted. As you see in step 6 of the accounting cycle, we create another trial balance that is adjusted (see [The Adjustment Process](#)).

6 National Retail Federation (NRF). "NRF Consumer Survey Points to Busy Holiday Season, Backs Up Economic Forecast and Import Numbers." October 27, 2017. <https://nrf.com/media-center/press-releases/nrf-consumer-survey-points-busy-holiday-season-backs-economic-forecast>

7 CEB Tower Group. "2015 Gift Card Sales to Reach New Peak of \$130 Billion." PR Newswire. December 8, 2015. <https://www.prnewswire.com/news-releases/2015-gift-card-sales-to-reach-new-peak-of-130-billion-300189615.html>

8 Sara Haralson. "Last-Minute Shoppers Rejoice! Starbucks Has You Covered." *Fortune*. December 22, 2015. <http://fortune.com/video/2015/12/22/starbucks-gift-cards/>

9 U.S. Securities and Exchange Commission. Communication from Starbucks Corporation regarding 2014 10-K Filing. November 14, 2014. <https://www.sec.gov/Archives/edgar/data/829224/000082922415000020/filename1.htm>

When constructing a trial balance, we must consider a few formatting rules, akin to those requirements for financial statements:

- The header must contain the name of the company, the label of a Trial Balance (Unadjusted), and the date.
- Accounts are listed in the accounting equation order with assets listed first followed by liabilities and finally equity.
- Amounts at the top of each debit and credit column should have a dollar sign.
- When amounts are added, the final figure in each column should be underscored.
- The totals at the end of the trial balance need to have dollar signs and be double-underscored.

Transferring information from T-accounts to the trial balance requires consideration of the final balance in each account. If the final balance in the ledger account (T-account) is a debit balance, you will record the total in the left column of the trial balance. If the final balance in the ledger account (T-account) is a credit balance, you will record the total in the right column.

Once all ledger accounts and their balances are recorded, the debit and credit columns on the trial balance are totaled to see if the figures in each column match each other. The final total in the debit column must be the same dollar amount that is determined in the final credit column. For example, if you determine that the final debit balance is \$24,000 then the final credit balance in the trial balance must also be \$24,000. If the two balances are not equal, there is a mistake in at least one of the columns.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		9,500
Salaries Expense	3,600	
Utility Expense	300	
Total	<u>\$34,000</u>	<u>\$34,000</u>

Cash			
Jan. 3	20,000	300	Jan. 12
Jan. 9	4,000	100	Jan. 14
Jan. 17	2,800	3,500	Jan. 18
Jan. 23	5,500	3,600	Jan. 20
Bal. 24,800			

Accounts Receivable			
Jan. 10	5,500	5,500	Jan. 23
Jan. 27	1,200		
Bal. 1,200			

Supplies	
Jan. 30	500
Bal. 500	

Equipment	
Jan. 5	3,500
Bal. 3,500	

Accounts Payable			
Jan. 18	3,500	3,500	Jan. 5
		500	Jan. 30
		Bal. 500	

Unearned Revenue	
	4,000 Jan. 9
Bal. 4,000	

Common Stock	
	20,000 Jan. 3
Bal. 20,000	

Dividends	
Jan. 14	100
Bal. 100	

Service Revenue	
	5,500 Jan. 10
	2,800 Jan. 17
	1,200 Jan. 27
Bal. 9,500	

Salaries Expense	
Jan. 20	3,600
Bal. 3,600	

Utility Expense	
Jan. 12	300
Bal. 300	

Let's now take a look at the T-accounts and unadjusted trial balance for Printing Plus to see how the information is transferred from the T-accounts to the unadjusted trial balance.

For example, Cash has a final balance of \$24,800 on the debit side. This balance is transferred to the Cash account in the debit column on the unadjusted trial balance. Accounts Receivable (\$1,200), Supplies (\$500), Equipment (\$3,500), Dividends (\$100), Salaries Expense (\$3,600), and Utility Expense (\$300) also have debit final balances in their T-accounts, so this information will be transferred to the debit column on the unadjusted trial balance. Accounts Payable (\$500), Unearned Revenue (\$4,000), Common Stock (\$20,000) and Service Revenue (\$9,500) all have credit final balances in their T-accounts. These credit balances would transfer to the

credit column on the unadjusted trial balance.

Once all balances are transferred to the unadjusted trial balance, we will sum each of the debit and credit columns. The debit and credit columns both total \$34,000, which means they are equal and in balance. However, just because the column totals are equal and in balance, we are still not guaranteed that a mistake is not present.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		9,500
Salaries Expense	3,600	
Utility Expense	300	
Total	<u>\$34,000</u>	<u>\$34,000</u>

What happens if the columns are not equal?

CONCEPTS IN PRACTICE

Enron and Arthur Andersen

One of the most well-known financial schemes is that involving the companies **Enron Corporation** and **Arthur Andersen**. **Enron** defrauded thousands by intentionally inflating revenues that did not exist. **Arthur Andersen** was the auditing firm in charge of independently verifying the accuracy of **Enron's** financial statements and disclosures. This meant they would review statements to make sure they aligned with GAAP principles, assumptions, and concepts, among other things.

It has been alleged that **Arthur Andersen** was negligent in its dealings with **Enron** and contributed to the collapse of the company. **Arthur Andersen** was brought up on a charge of obstruction of justice for shredding important documents related to criminal actions by **Enron**. They were found guilty but had that conviction overturned. However, the damage was done, and the company's reputation prevented it from operating as it had.^[10]

Locating Errors

Sometimes errors may occur in the accounting process, and the trial balance can make those errors apparent when it does not balance.

10 James Titcomb. "Arthur Andersen Returns 12 Years after Enron Scandal." *The Telegraph*. September 2, 2014. <https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11069713/Arthur-Andersen-returns-12-years-after-Enron-scandal.html>

One way to find the error is to take the difference between the two totals and divide the difference by two. For example, let's assume the following is the trial balance for Printing Plus.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends		100
Service Revenue		9,500
Salaries Expense	3,600	
Utility Expense	300	
Total	<u>\$33,900</u>	<u>\$34,100</u>

You notice that the balances are not the same. Find the difference between the two totals: $\$34,100 - \$33,900 = \$200$ difference. Now divide the difference by two: $\$200/2 = \100 . Since the credit side has a higher total, look carefully at the numbers on the credit side to see if any of them are \$100. The Dividends account has a \$100 figure listed in the credit column. Dividends normally have a debit balance, but here it is a credit. Look back at the Dividends T-account to see if it was copied onto the trial balance incorrectly. If the answer is the same as the T-account, then trace it back to the journal entry to check for mistakes. You may discover in your investigation that you copied the number from the T-account incorrectly. Fix your error, and the debit total will go up \$100 and the credit total down \$100 so that they will both now be \$34,000.

Another way to find an error is to take the difference between the two totals and divide by nine. If the outcome of the difference is a whole number, then you may have transposed a figure. For example, let's assume the following is the trial balance for Printing Plus.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	5,300	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		9,500
Salaries Expense	3,600	
Utility Expense	300	
Total	<u>\$35,800</u>	<u>\$34,000</u>

Find the difference between the two totals: $\$35,800 - \$34,000 = \$1,800$ difference. This difference divided by nine

is \$200 ($\$1,800/9 = \200). Looking at the debit column, which has the higher total, we determine that the Equipment account had transposed figures. The account should be \$3,500 and not \$5,300. We transposed the three and the five.

What do you do if you have tried both methods and neither has worked? Unfortunately, you will have to go back through one step at a time until you find the error.

If a trial balance is in balance, does this mean that all of the numbers are correct? Not necessarily. We can have errors and still be mathematically in balance. It is important to go through each step very carefully and recheck your work often to avoid mistakes early on in the process.

After the unadjusted trial balance is prepared and it appears error-free, a company might look at its financial statements to get an idea of the company's position before adjustments are made to certain accounts. A more complete picture of company position develops after adjustments occur, and an adjusted trial balance has been prepared. These next steps in the accounting cycle are covered in [The Adjustment Process](#).

YOUR TURN

Completing a Trial Balance

Complete the trial balance for Magnificent Landscaping Service using the following T-account final balance information for April 30, 2018.

Cash		Common Stock	
10,000	6,000		2,050
Bal. 4,000			Bal. 2,050

Accounts Receivable		Service Revenue	
400			2,000 400
Bal. 400			Bal. 2,400

Accounts Payable		Advertising Expense	
	50	100	
	Bal. 50	Bal. 100	

Solution

MAGNIFICENT LANDSCAPING SERVICE Trial Balance April 30, 2018		
	Debit	Credit
Cash	\$4,000	
Accounts receivable	400	
Accounts payable		50
Common stock		2,050
Service revenue		<u>2,400</u>
Advertising expense	100	
	<u>\$4,500</u>	<u>\$4,500</u>

THINK IT THROUGH

Correcting Errors in the Trial Balance

You own a small consulting business. Each month, you prepare a trial balance showing your company's position. After preparing your trial balance this month, you discover that it does not balance. The debit column shows \$2,000 more dollars than the credit column. You decide to investigate this error.

What methods could you use to find the error? What are the ramifications if you do not find and fix this error? How can you minimize these types of errors in the future?

Key Terms

abnormal balance account balance that is contrary to the expected normal balance of that account

account record showing increases and decreases to assets, liabilities, and equity found in the accounting equation

accounting cycle step-by-step process to record business activities and events to keep financial records up to date

book of original entry journal is often referred to as this because it is the place the information originally enters into the system

chart of accounts account numbering system that lists all the accounts a business uses in its day-to-day transactions

compound entry more than one account is listed under the debit and/or credit column of a journal entry

conceptual framework interrelated objectives and fundamentals of accounting principles for financial reporting

conservatism concept that if there is uncertainty in a potential financial estimate, a company should err on the side of caution and report the most conservative amount

contributed capital owner's investment (cash and other assets) in the business which typically comes in the form of common stock

cost principle everything the company owns or controls (assets) must be recorded at its value at the date of acquisition

credit records financial information on the right side of an account

debit records financial information on the left side of each account

double-entry accounting system requires the sum of the debits to equal the sum of the credits for each transaction

ending account balance difference between debits and credits for an account

expanded accounting equation breaks down the equity portion of the accounting equation into more detail to see the impact to equity from changes to revenues and expenses, and to owner investments and payouts

expense recognition principle (also, matching principle) matches expenses with associated revenues in the period in which the revenues were generated

full disclosure principle business must report any business activities that could affect what is reported on the financial statements

general ledger comprehensive listing of all of a company's accounts with their individual balances

going concern assumption absent any evidence to the contrary, assumption that a business will continue to operate in the indefinite future

journal record of all transactions

journalizing entering information into a journal; second step in the accounting cycle

monetary measurement system of using a monetary unit by which to value the transaction, such as the US dollar

normal balance expected balance each account type maintains, which is the side that increases

original source traceable record of information that contributes to the creation of a business transaction

period one operating cycle of a business, which could be a month, quarter, or year

posting takes all transactions from the journal during a period and moves the information to a general ledger (ledger)

prepaid expenses items paid for in advance of their use

revenue recognition principle principle stating that a company must recognize revenue in the period in which it is earned; it is not considered earned until a product or service has been provided

separate entity concept business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally

simple entry only one debit account and one credit account are listed under the debit and credit columns of a journal entry

stockholders' equity owner (stockholders') investments in the business and earnings

T-account graphic representation of a general ledger account in which each account is visually split into left and right sides

time period assumption companies can present useful information in shorter time periods such as years, quarters, or months

transaction business activity or event that has an effect on financial information presented on financial statements

trial balance list of all accounts in the general ledger that have nonzero balances

unadjusted trial balance trial balance that includes accounts before they have been adjusted

unearned revenue advance payment for a product or service that has yet to be provided by the company; the transaction is a liability until the product or service is provided



Summary

3.1 Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements

- The Financial Accounting Standards Board (FASB) is an independent, nonprofit organization that sets the standards for financial accounting and reporting standards for both public- and private-sector businesses in the United States, including generally accepted accounting principles (GAAP).
- GAAP are the concepts, standards, and rules that guide the preparation and presentation of financial statements.
- The Securities and Exchange Commission (SEC) is an independent federal agency that is charged with protecting the interests of investors, regulating stock markets, and ensuring companies adhere to GAAP requirements.
- The FASB uses a conceptual framework, which is a set of concepts that guide financial reporting.
- The revenue recognition principle requires companies to record revenue when it is earned. Revenue is earned when a product or service has been provided.
- The expense recognition principle requires that expenses incurred match with revenues earned in the same period. The expenses are associated with revenue generation.
- The cost principle records assets at their value at the date of acquisition. A company may not record what it estimates or thinks the value of the asset is, only what is verifiable. This verification is typically represented by an actual transaction.
- The full disclosure principle requires companies to relay any information to the public that may affect financials that are not readily available on the financial statements. This helps users of information make decisions that are more informed.
- The separate entity concept maintains that only business activities, and not the owner's personal financials, may be reported on company financial statements.
- Conservatism prescribes that a company should record expenses or losses when there is an expectation of their existence but only recognize gains or revenue when there is assurance that they will be realized.
- Monetary measurement requires a monetary unit be used to report financial information, such as the US

dollar. This makes information comparable.

- The going concern assumption assumes that a business will continue to operate in the foreseeable future. If there is a concern the business will not continue operating, this needs to be disclosed to management and other users of information.
- Time period assumption presents financial information in equal and short time frames, such as a month, quarter, or year.
- The accounting equation shows that assets must equal the sum of liabilities and equity. Transactions are analyzed with this equation to prepare for the next step in the accounting cycle.

3.2 Define and Describe the Expanded Accounting Equation and Its Relationship to Analyzing Transactions

- The expanded accounting equation breaks down the equity portion of the accounting equation into more detail to show common stock, dividends, revenue, and expenses individually.
- The chart of accounts is a numbering system that lists all of a company's accounts in the order in which they appear on the financial statements, beginning with the balance sheet accounts and then the income statement accounts.

3.3 Define and Describe the Initial Steps in the Accounting Cycle

- Step 1 in the accounting cycle: Identifying and analyzing transactions requires a company to take information from an original source, identify its purpose as a financial transaction, and connect that information to an accounting equation.
- Step 2 in the accounting cycle: Recording transactions to a journal takes financial information identified in the transaction and copies that information, using the accounting equation, into a journal. The journal is a record of all transactions.
- Step 3 in the accounting cycle: Posting journal information to a ledger takes all information transferred to the journal and posts it to a general ledger. The general ledger is an accumulation of all accounts a company maintains and their balances.
- Step 4 in the accounting cycle: Preparing an unadjusted trial balance requires transfer of information from the general ledger (T-accounts) to an unadjusted trial balance showing all account balances.

3.4 Analyze Business Transactions Using the Accounting Equation and Show the Impact of Business Transactions on Financial Statements

- Both the basic and the expanded accounting equations are useful in analyzing how any transaction affects a company's financial statements.

3.5 Use Journal Entries to Record Transactions and Post to T-Accounts

- Journals are the first place where information is entered into the accounting system, which is why they are often referred to as books of original entry.
- Journalizing transactions transfers information from accounting equation analysis to a record of each transaction.
- There are several formatting rules for journalizing transactions that include where to put debits and credits, which account titles come first, the need for a date and inclusion of a brief description.
- Step 3 in the accounting cycle posts journal information to the general ledger (T-accounts). Final balances in each account must be calculated before transfer to the trial balance occurs.

3.6 Prepare a Trial Balance

- The trial balance contains a listing of all accounts in the general ledger with nonzero balances. Information is transferred from the T-accounts to the trial balance.
- Sometimes errors occur on the trial balance, and there are ways to find these errors. One may have to go

through each step of the accounting process to locate an error on the trial balance.



Multiple Choice

1. **LO 3.1** That a business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally, is known as which of the following?
 - A. separate entity concept
 - B. monetary measurement concept
 - C. going concern assumption
 - D. time period assumption
2. **LO 3.1** That companies can present useful information in shorter time periods such as years, quarters, or months is known as which of the following?
 - A. separate entity concept
 - B. monetary measurement concept
 - C. going concern assumption
 - D. time period assumption
3. **LO 3.1** The system of using a monetary unit, such as the US dollar, to value the transaction is known as which of the following?
 - A. separate entity concept
 - B. monetary measurement concept
 - C. going concern assumption
 - D. time period assumption
4. **LO 3.1** Which of the following terms is used when assuming a business will continue to operate in the foreseeable future?
 - A. separate entity concept
 - B. monetary measurement concept
 - C. going concern assumption
 - D. time period assumption
5. **LO 3.1** The independent, nonprofit organization that sets financial accounting and reporting standards for both public- and private-sector businesses that use generally accepted accounting principles (GAAP) in the United States is which of the following?
 - A. Financial Accounting Standards Board (FASB)
 - B. generally accepted accounting principles (GAAP)
 - C. Securities and Exchange Commission (SEC)
 - D. conceptual framework
6. **LO 3.1** The standards, procedures, and principles companies must follow when preparing their financial statements are known as which of the following?
 - A. Financial Accounting Standards Board (FASB)
 - B. generally accepted accounting principles (GAAP)
 - C. Securities and Exchange Commission (SEC)
 - D. conceptual framework

7. **LO 3.1** These are used by the FASB, and it is a set of concepts that guide financial reporting.
- A. Financial Accounting Standards Board (FASB)
 - B. generally accepted accounting principles (GAAP)
 - C. Securities and Exchange Commission (SEC)
 - D. conceptual framework
8. **LO 3.1** This is the independent federal agency protecting the interests of investors, regulating stock markets, and ensuring companies adhere to GAAP requirements.
- A. Financial Accounting Standards Board (FASB)
 - B. generally accepted accounting principles (GAAP)
 - C. Securities and Exchange Commission (SEC)
 - D. conceptual framework
9. **LO 3.1** Which of the following is the principle that a company must recognize revenue in the period in which it is earned; it is not considered earned until a product or service has been provided?
- A. revenue recognition principle
 - B. expense recognition (matching) principle
 - C. cost principle
 - D. full disclosure principle
10. **LO 3.1** Which of the following is the principle that a business must report any business activities that could affect what is reported on the financial statements?
- A. revenue recognition principle
 - B. expense recognition (matching) principle
 - C. cost principle
 - D. full disclosure principle
11. **LO 3.1** Also known as the historical cost principle, _____ states that everything the company owns or controls (assets) must be recorded at their value at the date of acquisition.
- A. revenue recognition principle
 - B. expense recognition (matching) principle
 - C. cost principle
 - D. full disclosure principle
12. **LO 3.1** Which of the following principles matches expenses with associated revenues in the period in which the revenues were generated?
- A. revenue recognition principle
 - B. expense recognition (matching) principle
 - C. cost principle
 - D. full disclosure principle
13. **LO 3.2** Which of the following does *not* accurately represent the accounting equation?
- A. Assets – Liabilities = Stockholders' Equity
 - B. Assets – Stockholders' Equity = Liabilities
 - C. Assets = Liabilities + Stockholders' Equity
 - D. Assets + Liabilities = Stockholders' Equity

14. **L0** 3.2 Which of these statements is *false*?
- A. $\text{Assets} = \text{Liabilities} + \text{Equity}$
 - B. $\text{Assets} - \text{Liabilities} = \text{Equity}$
 - C. $\text{Liabilities} - \text{Equity} = \text{Assets}$
 - D. $\text{Liabilities} = \text{Assets} - \text{Equity}$
15. **L0** 3.2 Which of these accounts is an asset?
- A. Common Stock
 - B. Supplies
 - C. Accounts Payable
 - D. Fees Earned
16. **L0** 3.2 Which of these accounts is a liability?
- A. Accounts Receivable
 - B. Supplies
 - C. Salaries Expense
 - D. Accounts Payable
17. **L0** 3.2 If equity equals \$100,000, which of the following is true?
- A. Assets exceed liabilities by \$100,000.
 - B. Liabilities exceed equity by \$100,000.
 - C. $\text{Assets} + \text{liabilities} = \$100,000$.
 - D. None of the above is true.
18. **L0** 3.3 Which process of the accounting cycle often requires the most analytical thought?
- A. making a journal entry
 - B. posting transactions to accounts
 - C. summarizing the trial balance
 - D. preparing the financial statements
19. **L0** 3.3 The step-by-step process to record business activities and events to keep financial records up to date is _____.
- A. day-to-day cycle
 - B. accounting cycle
 - C. general ledger
 - D. journal
20. **L0** 3.3 One operating cycle of a business, which could be a month, quarter, or year, is commonly referred to as which of the following?
- A. period
 - B. round
 - C. tally
 - D. mark
21. **L0** 3.3 _____ takes all transactions from the journal during a period and moves the information to a general ledger (ledger).
- A. Hitching
 - B. Posting
 - C. Vetting
 - D. Laxing

22. **L0** 3.4 Which of these events will *not* be recognized?
- A. A service is performed, but the payment is not collected on the same day.
 - B. Supplies are purchased. They are not paid for; the company will be billed.
 - C. A copy machine is ordered. It will be delivered in two weeks.
 - D. Electricity has been used but has not been paid for.
23. **L0** 3.4 A company purchased a building twenty years ago for \$150,000. The building currently has an appraised market value of \$235,000. The company reports the building on its balance sheet at \$235,000. What concept or principle has been violated?
- A. separate entity concept
 - B. recognition principle
 - C. monetary measurement concept
 - D. cost principle
24. **L0** 3.4 What is the impact on the accounting equation when a current month's utility expense is paid?
- A. both sides increase
 - B. both sides decrease
 - C. only the Asset side changes
 - D. neither side changes
25. **L0** 3.4 What is the impact on the accounting equation when a payment of account payable is made?
- A. both sides increase
 - B. both sides decrease
 - C. only the Asset side changes
 - D. neither side changes
26. **L0** 3.4 What is the impact on the accounting equation when an accounts receivable is collected?
- A. both sides increase
 - B. both sides decrease
 - C. only the Asset side changes
 - D. the total of neither side changes
27. **L0** 3.4 What is the impact on the accounting equation when a sale occurs?
- A. both sides increase
 - B. both sides decrease
 - C. only the Asset side changes
 - D. neither side changes
28. **L0** 3.4 What is the impact on the accounting equation when stock is issued, in exchange for assets?
- A. both sides increase
 - B. both sides decrease
 - C. only the Asset side changes
 - D. neither side changes
29. **L0** 3.5 Which of the following accounts is increased by a debit?
- A. Common Stock
 - B. Accounts Payable
 - C. Supplies
 - D. Service Revenue

30. **L0** 3.5 Which of the following accounts does not increase with a debit entry?
- A. Retained Earnings
 - B. Buildings
 - C. Prepaid Rent
 - D. Electricity Expense
31. **L0** 3.5 Which of the following pairs increase with credit entries?
- A. supplies and retained earnings
 - B. rent expense and unearned revenue
 - C. prepaid rent and common stock
 - D. unearned service revenue and accounts payable
32. **L0** 3.5 Which of the following pairs of accounts are impacted the same with debits and credits?
- A. Cash and Unearned Service Revenue
 - B. Electricity Expense and Office Supplies
 - C. Accounts Receivable and Accounts Payable
 - D. Buildings and Common Stock
33. **L0** 3.5 Which of the following accounts will normally have a debit balance?
- A. Common Stock
 - B. Fees Earned
 - C. Supplies
 - D. Accounts Payable
34. **L0** 3.5 What type of account is prepaid insurance?
- A. Stockholders' Equity
 - B. Expense
 - C. Liability
 - D. Asset
35. **L0** 3.5 Unearned service revenue occurs when which of the following occurs?
- A. company receives cash from a customer before performing the service
 - B. company pays cash before receiving a service from a supplier
 - C. company pays cash after receiving a service from a supplier
 - D. company receives cash from a customer after performing a service
36. **L0** 3.5 Which set of accounts has the same type of normal balance?
- A. Cash, accounts payable
 - B. Prepaid rent, unearned service revenue
 - C. Dividends, common stock
 - D. Accounts payable, retained earnings
37. **L0** 3.5 Which of these transactions requires a debit entry to Cash?
- A. paid balance due to suppliers
 - B. sold merchandise on account
 - C. collected balance due from customers
 - D. purchased supplies for cash

38. **L0 3.5** Which of these transactions requires a credit entry to Revenue?
- A. received cash from services performed this month
 - B. collected balance due from customers
 - C. received cash from bank loan
 - D. refunded a customer for a defective product
39. **L0 3.5** Which of these accounts commonly requires both debit and credit entries?
- A. Sales Revenue
 - B. Utilities Expense
 - C. Accounts Receivable
 - D. Common Stock
40. **L0 3.5** Which of the following accounting records is the main source of information used to prepare the financial statements?
- A. journal entries
 - B. T-accounts
 - C. trial balance
 - D. chart of accounts
41. **L0 3.5** Which of the following financial statements should be prepared first?
- A. Balance Sheet
 - B. Income Statement
 - C. Retained Earnings Statement
 - D. Statement of Cash Flows



Questions

1. **L0 3.1** Explain what conservatism means, and give an example in your own words.
2. **L0 3.2** State the accounting equation, and explain what each part represents.
3. **L0 3.2** How do revenues and expenses affect the accounting equation?
4. **L0 3.2** Does every transaction affect both sides of the accounting equation? Explain your answer.
5. **L0 3.3** Which is the “book of original entry”?
6. **L0 3.4** What is the effect on the accounting equation when a business purchases supplies on account?
7. **L0 3.4** What is the effect on the accounting equation when a business pays the balance due on accounts payable?
8. **L0 3.4** Is it still necessary to record a transaction if it has no net effect on the accounting equation? Explain your answer.
9. **L0 3.4** Why does the combined total of the company’s liabilities and equity always equal the total of the company’s assets?
10. **L0 3.5** What do the terms “debit” and “credit” mean?
11. **L0 3.5** Will an accounts receivable balance increase with a debit or a credit entry? How do you know?

12. **L0** 3.5 What types of accounts will increase with a credit?
13. **L0** 3.5 What is a journal?
14. **L0** 3.5 Why is a journal referred to as the “book of original entry”?
15. **L0** 3.5 What does the term *recognize* mean?
16. **L0** 3.5 What are the rules you should follow when recording journal entries?
17. **L0** 3.5 What is the general ledger?
18. **L0** 3.5 Explain the steps in posting.
19. **L0** 3.5 What is a T-account? When would we use T-accounts?
20. **L0** 3.5 Explain normal balances. Give three examples of accounts that will normally have a debit balance and three accounts that will normally have a credit balance.
21. **L0** 3.5 What is a prepaid account? What type of account is it?
22. **L0** 3.5 What is an unearned account? What type of account is it?
23. **L0** 3.5 Explain what a T-account is and what purpose it serves.
24. **L0** 3.5 Can a credit entry be described as a generally positive or negative transaction? Explain.
25. **L0** 3.5 What types of accounts are increased with a debit?
26. **L0** 3.5 What types of accounts are increased with a credit?
27. **L0** 3.5 What does an account’s “normal balance” indicate?
28. **L0** 3.5 Does the order in which financial statements are prepared matter?
29. **L0** 3.5 Answer the following questions about the trial balance: What is the purpose of it? What is the primary usefulness of it?



Exercise Set A

EA1. **L0** 3.1 Match the correct term with its definition.

A. cost principle	i. if uncertainty in a potential financial estimate, a company should err on the side of caution and report the most conservative amount
B. full disclosure principle	ii. also known as the historical cost principle, states that everything the company owns or controls (assets) must be recorded at their value at the date of acquisition
C. separate entity concept	iii. (also referred to as the matching principle) matches expenses with associated revenues in the period in which the revenues were generated
D. monetary measurement concept	iv. business must report any business activities that could affect what is reported on the financial statements
E. conservatism	v. system of using a monetary unit by which to value the transaction, such as the US dollar
F. revenue recognition principle	vi. period of time in which you performed the service or gave the customer the product is the period in which revenue is recognized
G. expense recognition principle	vii. business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally

EA2. **L0** 3.2 Consider the following accounts, and determine if the account is an asset (A), a liability (L), or equity (E).

- A. Accounts Payable
- B. Cash
- C. Dividends
- D. Notes Payable

EA3. **L0** 3.2 Provide the missing amounts of the accounting equation for each of the following companies.

	Gianni	Forest
Assets	\$222,000	\$387,000
Liabilities	?	7,000
Equity	147,000	?

EA4. **L0 3.2** Identify the financial statement on which each of the following accounts would appear: the income statement (IS), the retained earnings statement (RE), or the Balance Sheet (BS).

- A. Insurance Expense
- B. Accounts Receivable
- C. Office Supplies
- D. Sales Revenue
- E. Common Stock
- F. Notes Payable

EA5. **L0 3.2** Cromwell Company has the following trial balance account balances, given in no certain order, as of December 31, 2018. Using the information provided, prepare Cromwell's annual financial statements (omit the Statement of Cash Flows).

Supplies	\$ 865
Fees earned	22,850
Accounts receivable	2,580
Accounts payable	1,945
Office furniture	12,685
Rent expense	12,240
Retained earnings	3,600
Cash	4,695
Electricity expense	1,380
Common stock	10,000
Miscellaneous expenses	1,450
Dividends	2,500

EA6. **L0 3.3** From the following list, identify which items are considered original sources:

- A. prepaid insurance
- B. bank statement
- C. sales ticket
- D. general journal
- E. trial balance
- F. balance sheet
- G. telephone bill
- H. invoice from supplier
- I. company sales account
- J. income statement

EA7. **L0 3.4** Indicate what impact the following transactions would have on the accounting equation, Assets = Liabilities + Equity.

		Impact 1	Impact 2
A.	Received cash from issuance of common stock		
B.	Sold goods to customers on account		
C.	Collected cash from customer sales made in previous month		
D.	Paid cash to vendors for supplies delivered last month		
E.	Purchased inventory on account		

Table 3.4

EA8. **L0 3.4** For the following accounts please indicate whether the normal balance is a debit or a credit.

- A. Sales
- B. Dividends
- C. Office Supplies
- D. Retained Earnings
- E. Accounts Receivable
- F. Prepaid Rent
- G. Prepaid Insurance
- H. Wages Payable
- I. Building
- J. Wages Expense

EA9. **L0 3.4** Indicate what impact the following transactions would have on the accounting equation, Assets = Liabilities + Equity.

		Impact 1	Impact 2
A.	Paid monthly note payment to bank		
B.	Sold inventory on account		
C.	Bought supplies, to be paid for next month		
D.	Received cash from sales this month		
E.	Paid for inventory purchased on account last month		

Table 3.5

EA10. **L0** 3.4 Identify the normal balance for each of the following accounts. Choose Dr for Debit; Cr for Credit.

		Normal balance
A.	Utilities Expense	
B.	Cash	
C.	Equipment	
D.	Rent Revenue	
E.	Preferred Stock	
F.	Interest Payable	

Table 3.6

EA11. **L0** 3.4 Identify whether each of the following transactions would be recorded with a debit (Dr) or credit (Cr) entry.

		Debit or credit?
A.	Cash increase	
B.	Supplies decrease	
C.	Accounts Payable increase	
D.	Common Stock decrease	
E.	Interest Payable decrease	
F.	Notes Payable decrease	

Table 3.7

EA12. **L0** 3.4 Identify whether each of the following transactions would be recorded with a debit (Dr) or credit (Cr) entry.

		Debit or credit?
A.	Equipment decrease	
B.	Common Stock Sold increase	
C.	Gas and Oil Expense increase	
D.	Service revenue decrease	
E.	Miscellaneous Expense decrease	
F.	Bonds Payable decrease	

Table 3.8

EA13. **L0** 3.4 Identify whether ongoing transactions posted to the following accounts would normally have *only* debit entries (Dr), *only* credit entries (Cr), or *both* debit and credit entries (both).

		Type of entry
A.	Accounts Payable	
B.	Cash	
C.	Gas and Oil Expense	
D.	Rent Revenue	
E.	Supplies Expense	
F.	Common Stock	

Table 3.9

EA14. **L0** 3.5 Determine whether the balance in each of the following accounts increases with a debit or a credit.

- A. Cash
- B. Common Stock
- C. Equipment
- D. Accounts Payable
- E. Fees Earned
- F. Electricity Expense

EA15. **L0 3.5** Journalize for Harper and Co. each of the following transactions or state no entry required and explain why. Be sure to follow proper journal writing rules.

- A. A corporation is started with an investment of \$50,000 in exchange for stock.
- B. Equipment worth \$4,800 is ordered.
- C. Office supplies worth \$750 are purchased on account.
- D. A part-time worker is hired. The employee will work 15–20 hours per week starting next Monday at a rate of \$18 per hour.
- E. The equipment is received along with the invoice. Payment is due in three equal monthly installments, with the first payment due in sixty days.

EA16. **L0 3.5** Discuss how each of the following transactions for Watson, International, will affect assets, liabilities, and stockholders' equity, and prove the company's accounts will still be in balance.

- A. An investor invests an additional \$25,000 into a company receiving stock in exchange.
- B. Services are performed for customers for a total of \$4,500. Sixty percent was paid in cash, and the remaining customers asked to be billed.
- C. An electric bill was received for \$35. Payment is due in thirty days.
- D. Part-time workers earned \$750 and were paid.
- E. The electric bill in "C" is paid.

EA17. **L0 3.5** For each item that follows, indicate whether a debit or a credit applies.

- A. increase in prepaid insurance
- B. increase in utilities expense
- C. increase in commissions earned
- D. increase in supplies
- E. decrease in retained earnings
- F. decrease in income taxes payable
- G. increase in unearned revenue
- H. increase in salaries expense
- I. decrease in notes receivable
- J. increase in common stock

EA18. **L0 3.5** Indicate whether each account that follows has a normal debit or credit balance.

- A. Unearned Revenue
- B. Office Machines
- C. Prepaid Rent
- D. Cash
- E. Legal Fees Earned
- F. Salaries Payable
- G. Dividends
- H. Accounts Receivable
- I. Advertising Expense
- J. Retained Earnings

EA19. **L0 3.5** A business has the following transactions:

- The business is started by receiving cash from an investor in exchange for common stock \$20,000
- The business purchases supplies on account \$500
- The business purchases furniture on account \$2,000
- The business renders services to various clients on account totaling \$9,000
- The business pays salaries \$2,000
- The business pays this month's rent \$3,000
- The business pays for the supplies purchased on account.
- The business collects from one of its clients for services rendered earlier in the month \$1,500.

What is total income for the month?

EA20. **L0 3.5** Prepare journal entries to record the following transactions.

- A. January 22, purchased, an asset, merchandise inventory
- B. on account for \$2,800.
- C. February 10, paid creditor for part of January 22 purchase, \$1,600

EA21. **L0 3.5** Prepare journal entries to record the following transactions.

- A. July 1, issued common stock for cash, \$15,000
- B. July 15, purchased supplies, on account, \$1,800
- C. July 25, billed customer for accounting services provided, \$950

EA22. **L0 3.5** Prepare journal entries to record the following transactions.

- A. March 1, purchased land for cash, \$20,000
- B. March 11, purchased merchandise inventory, on account, \$18,500
- C. March 15, Sold merchandise to customer for cash, \$555

EA23. **L0 3.5** Post the following February transactions to T-accounts for Accounts Receivable and Cash, indicating the ending balance (assume no beginning balances in these accounts).

- A. provided legal services to customers for cash, \$5,600
- B. provided legal services to customers on account, \$4,700
- C. collected cash from customer accounts, \$3,500

EA24. **L0 3.5** Post the following November transactions to T-accounts for Accounts Payable and Inventory, indicating the ending balance (assume no beginning balances in these accounts).

- A. purchased merchandise inventory on account, \$22,000
- B. paid vendors for part of inventory purchased earlier in month, \$14,000
- C. purchased merchandise inventory for cash, \$6,500

EA25. **L0 3.6** Prepare an unadjusted trial balance, in correct format, from the alphabetized account information as follows. Assume all accounts have normal balances.

Accounts payable	\$11,100
Accounts receivable	16,500
Administrative expense	54,712
Cash	64,888
Common stock	50,000
Service revenue	75,000



Exercise Set B

EB1. **L0** 3.1 Match the correct term with its definition.

A. Financial Accounting Standards Board (FASB)	i. used by the FASB, which is a set of concepts that guide financial reporting
B. generally accepted accounting principles (GAAP)	ii. independent, nonprofit organization that sets financial accounting and reporting standards for both public- and private-sector businesses that use generally accepted accounting principles (GAAP) here in the United States
C. Securities and Exchange Commission (SEC)	iii. standards, procedures, and principles companies must follow when preparing their financial statements
D. conceptual framework	iv. assumes a business will continue to operate in the foreseeable future
E. going concern assumption	v. independent federal agency protecting the interests of investors, regulating stock markets, and ensuring companies adhere to GAAP requirements
F. time period assumption	vi. companies can present useful information in shorter time periods such as years, quarters, or months

EB2. **L0** 3.2 Consider the following accounts and determine if the account is an asset (A), a liability (L), or equity (E).

- A. Accounts Receivable
- B. Sales Revenue
- C. Land
- D. Unearned Revenue

EB3. **L0** 3.2 Provide the missing amounts of the accounting equation for each of the following companies.

	Elias	Patel
Assets	?	\$125,000
Liabilities	\$ 33,000	?
Equity	186,000	63,000

EB4. **L0 3.3** From the following list, identify which items are considered original sources:

- A. accounts receivable
- B. receipt from post office for post office box
- C. purchase order
- D. general ledger
- E. adjusted trial balance
- F. statement of retained earnings
- G. electric bill
- H. packing slip
- I. company expense account
- J. statement of cash flows

EB5. **L0 3.4** Indicate what impact the following transactions would have on the accounting equation, Assets = Liabilities + Equity.

		Impact 1	Impact 2
A.	Paid this month's utility bill		
B.	Purchased supplies for cash		
C.	Received cash for services performed		
D.	Collected cash from customer accounts receivable		
E.	Paid creditors on account		

Table 3.10

EB6. **L0 3.4** For the following accounts indicate whether the normal balance is a debit or a credit.

- A. Unearned Revenue
- B. Interest Expense
- C. Rent Expense
- D. Rent Revenue
- E. Accounts Payable
- F. Cash
- G. Supplies
- H. Accounts Payable
- I. Equipment
- J. Utilities Expense

EB7. **L0** 3.4 Which two accounts are affected by each of the following transactions?

		Account 1	Account 2
A.	Received cash from issuance of common stock		
B.	Purchased land by issuing a note payable		
C.	Paid balance on account for last month's inventory purchases		
D.	Received cash from customers for this month's sales		
E.	Sold merchandise to customers on account		

Table 3.11

EB8. **L0** 3.4 Identify the normal balance for each of the following accounts. Choose Dr for Debit; Cr for Credit.

		Normal balance
A.	Insurance Expense	
B.	Accounts Receivable	
C.	Office Supplies	
D.	Sales Revenue	
E.	Common Stock	
F.	Notes Payable	

Table 3.12

EB9. **L0** 3.4 Identify whether each of the following transactions would be recorded with a debit (Dr) or credit (Cr) entry.

		Debit or credit?
A.	Cash decrease	
B.	Supplies increase	
C.	Accounts Payable decrease	
D.	Common Stock increase	
E.	Accounts Payable increase	
F.	Notes Payable increase	

Table 3.13

EB10. **L0** 3.4 Identify whether each of the following transactions would be recorded with a debit (Dr) or credit (Cr) entry.

		Debit or credit?
A.	Equipment increase	
B.	Dividends Paid increase	
C.	Repairs Expense increase	
D.	Service revenue increase	
E.	Miscellaneous Expense increase	
F.	Bonds Payable increase	

Table 3.14

EB11. **L0 3.4** Identify whether ongoing transactions posted to the following accounts would normally have *only* debit entries (Dr), *only* credit entries (Cr), or *both* debit and credit entries (both).

		Type of entry
A.	Notes Payable	
B.	Accounts Receivable	
C.	Utilities Expense	
D.	Sales Revenue	
E.	Insurance Expense	
F.	Dividends	

Table 3.15

EB12. **L0 3.2 L0 3.4** West End Inc., an auto mechanic shop, has the following account balances, given in no certain order, for the quarter ended March 31, 2019. Based on the information provided, prepare West End's annual financial statements (omit the Statement of Cash Flows).

Electricity expense	\$ 2,365
Accounts payable	4,835
Dividends	1,200
Garage machines	145,000
Office supplies	235
Repair revenue	68,245
Mortgage interest expense	12,240
Accounts receivable	2,580
Retained earnings	23,600
Miscellaneous expenses	725
Cash	10,745
Common stock	150,000
Garage supplies	1,565
Real estate tax expense	5,200
Waiting room furniture	3,450
Machine maintenance expense	1,375
Mechanic shop	185,000
Mortgage payable	125,000

Prepare West End's annual financial statements. (Omit the Statement of Cash Flows.)

EB13. **L0 3.5** State whether the balance in each of the following accounts increases with a debit or a credit.

- Office Supplies
- Retained Earnings
- Salaries Expense
- Accounts Receivable
- Service Revenue

EB14. **L0 3.5** Journalize each of the following transactions or state no entry required and explain why. Be sure to follow proper journal writing rules.

- A. A company is started with an investment of a machine worth \$40,000. Common stock is received in exchange.
- B. Office furniture is ordered. The furniture worth \$7,850 will be delivered in one week. The payment will be due forty-five days after delivery.
- C. An advertisement was run in the newspaper at a total cost of \$250. Cash was paid when the order was placed.
- D. The office furniture is delivered.
- E. Services are performed for a client. The client was billed for \$535.

EB15. **L0 3.5** Discuss how each of the following transactions will affect assets, liabilities, and stockholders' equity, and prove the company's accounts will still be in balance.

- A. A company purchased \$450 worth of office supplies on credit.
- B. The company parking lot was plowed after a blizzard. A check for \$75 was given to the plow truck operator.
- C. \$250 was paid on account.
- D. A customer paid \$350 on account.
- E. Provided services for a customer, \$500. The customer asked to be billed.

EB16. **L0 3.5** For each of the following items, indicate whether a debit or a credit applies.

- A. increase in retained earnings
- B. decrease in prepaid rent
- C. increase in dividends
- D. decrease in salaries payable
- E. increase in accounts receivable
- F. decrease in common stock
- G. decrease in prepaid insurance
- H. decrease in advertising expense
- I. decrease in unearned service fees
- J. increase in office equipment

EB17. **L0 3.5** Indicate whether each of the following accounts has a normal debit or credit balance.

- A. prepaid landscaping expense
- B. common stock
- C. delivery vans
- D. maintenance expense
- E. retained earnings
- F. office supplies
- G. revenue earned
- H. accounts payable
- I. unearned painting revenue
- J. interest payable

EB18. L0 3.5 Krespy Corp. has a cash balance of \$7,500 before the following transactions occur:

- A. received customer payments of \$965
- B. supplies purchased on account \$435
- C. services worth \$850 performed, 25% is paid in cash the rest will be billed
- D. corporation pays \$275 for an ad in the newspaper
- E. bill is received for electricity used \$235.
- F. dividends of \$2,500 are distributed

What is the balance in cash after these transactions are journalized and posted?

EB19. L0 3.5 A business has the following transactions:

- A. The business is started by receiving cash from an investor in exchange for common stock \$10,000.
- B. Rent of \$1,250 is paid for the first month.
- C. Office supplies are purchased for \$375.
- D. Services worth \$3,450 are performed. Cash is received for half.
- E. Customers pay \$1,250 for services to be performed next month.
- F. \$6,000 is paid for a one year insurance policy.
- G. We receive 25% of the money owed by customers in "D".
- H. A customer has placed an order for \$475 of services to be done this coming week.

How much total revenue does the company have?

EB20. L0 3.5 Prepare journal entries to record the following transactions.

- A. November 19, purchased merchandise inventory, on account, \$12,000
- B. November 29, paid creditor for part of November 19 purchase, \$10,000

EB21. L0 3.5 Prepare journal entries to record the following transactions:

- A. December 1, collected balance due from customer account, \$5,500
- B. December 12, paid creditors for supplies purchased last month, \$4,200
- C. December 31, paid cash dividend to stockholders, \$1,000

EB22. L0 3.5 Prepare journal entries to record the following transactions:

- A. October 9, issued common stock in exchange for building, \$40,000
- B. October 12, purchased supplies on account, \$3,600
- C. October 24, paid cash dividend to stockholders, \$2,500

EB23. L0 3.5 Post the following August transactions to T-accounts for Accounts Payable and Supplies, indicating the ending balance (assume no beginning balances in these accounts):

- A. purchased supplies on account, \$600
- B. paid vendors for supplies delivered earlier in month, \$500
- C. purchased supplies for cash, \$450

EB24. L0 3.5 Post the following July transactions to T-accounts for Accounts Receivable and Cash, indicating the ending balance (assume no beginning balances in these accounts):

- A. sold products to customers for cash, \$8,500
- B. sold products to customers on account, \$2,900
- C. collected cash from customer accounts, \$1,600

EB25. **LO 3.6** Prepare an unadjusted trial balance, in correct format, from the alphabetized account information as follows. Assume all accounts have normal balances.

Accounts payable	\$ 8,005
Accounts receivable	12,500
Cash	56,015
Common stock	28,000
Fees earned revenue	75,510
Operating expense	43,000



Problem Set A

PA1. **LO 3.1** For each of the following situations write the principle, assumption, or concept that justifies or explains what occurred.

- A. A landscaper received a customer's order and cash prepayment to install sod at a house that would not be ready for installation until March of next year. The owner should record the revenue from the customer order in March of next year, not in December of this year.
- B. A company divides its income statements into four quarters for the year.
- C. Land is purchased for \$205,000 cash; the land is reported on the balance sheet of the purchaser at \$205,000.
- D. Brandy's Flower Shop is forecasting its balance sheet for the next five years.
- E. When preparing financials for a company, the owner makes sure that the expense transactions are kept separate from expenses of the other company that he owns.
- F. A company records the expenses incurred to generate the revenues reported.

PA2. **L0** 3.2 Assuming the following account balances, what is the missing value?

Assets	\$865,430
Liabilities	?
Equity	759,121

PA3. **L0** 3.2 **L0** 3.4 Assuming the following account balance changes for the period, what is the missing value?

Assets	\$246,300
Liabilities	?
Common stock	160,000
Dividends	30,000
Revenue	245,800
Expenses	175,000

PA4. **L0** 3.2 **L0** 3.4 Assuming the following account balance changes for the period, what is the missing value?

Assets	\$450,600
Liabilities	250,000
Common stock	120,000
Dividends	?
Revenue	433,600
Expenses	323,000

PA5. **L0** 3.2 **L0** 3.4 Identify the financial statement on which each of the following account categories would appear: the balance sheet (BS), the income statement (IS), or the retained earnings statement (RE). Indicate the normal balance (Dr for debit; Cr for credit) for each account category.

	Financial statement	Normal balance
Assets		
Common stock		
Dividends		
Expenses		
Liabilities		
Revenue		

Table 3.16

PA6. **L0** 3.4 Indicate what impact (+ for increase; – for decrease) the following transactions would have on the accounting equation, $\text{Assets} = \text{Liabilities} + \text{Equity}$.

		Impact 1	Impact 2
A.	Issued stock for cash		
B.	Purchased supplies on account		
C.	Paid employee salaries		
D.	Paid note payment to bank		
E.	Collected balance on accounts receivable		

Table 3.17

PA7. **L0** 3.4 Indicate how changes in the following types of accounts would be recorded (Dr for debit; Cr for credit).

		Increase	Decrease
A.	Asset accounts		
B.	Liability accounts		
C.	Common stock		
D.	Revenue		
E.	Expense		

Table 3.18

PA8. **L0** 3.4 Identify the normal balance (Dr for Debit; Cr for Credit) and type of account (A for asset, L for liability, E for equity, E-rev for revenue, E-exp for expense, and E-eq for equity) for each of the following items.

		Normal balance	Account type
A.	Accounts Payable		
B.	Supplies		
C.	Inventory		
D.	Common Stock		
E.	Dividends		
F.	Salaries Expense		

Table 3.19

PA9. **L0** 3.4 Indicate the net effect (+ for increase; – for decrease; 0 for no effect) of each of the following transactions on each part of the accounting equation, Assets = Liabilities + Equity. For example, for payment of an accounts payable balance, A (–) = L (–) + E (0).

- A. sale of merchandise to customer on account
- B. payment on note payable
- C. purchase of equipment for cash
- D. collection of accounts receivable
- E. purchase of supplies on account

PA10. **L0** 3.4 Identify whether the following transactions would be recorded with a debit (Dr) or credit (Cr) entry. Indicate the normal balance of the account.

	Transaction	Debit or credit?	Normal balance
A.	Equipment increase		
B.	Dividends Paid increase		
C.	Repairs Expense increase		
D.	Service revenue decrease		
E.	Miscellaneous Expense increase		
F.	Bonds Payable decrease		

Table 3.20

PA11. **L0** 3.5 The following information is provided for the first month of operations for Legal Services Inc.:

- A. The business was started by selling \$100,000 worth of common stock.
- B. Six months' rent was paid in advance, \$4,500.
- C. Provided services in the amount of \$1,000. The customer will pay at a later date.
- D. An office worker was hired. The worker will be paid \$275 per week.
- E. Received \$500 in payment from the customer in "C".
- F. Purchased \$250 worth of supplies on credit.
- G. Received the electricity bill. We will pay the \$110 in thirty days.
- H. Paid the worker hired in "D" for one week's work.
- I. Received \$100 from a customer for services we will provide next week.
- J. Dividends in the amount of \$1,500 were distributed.

Prepare the necessary journal entries to record these transactions. If an entry is not required for any of these transactions, state this and explain why.

PA12. **L0** 3.5 Sewn for You had the following transactions in its first week of business.

- A. Jessica Johansen started Sewn for You, a seamstress business, by contributing \$20,000 and receiving stock in exchange.
- B. Paid \$2,250 to cover the first three months' rent.
- C. Purchased \$500 of sewing supplies. She paid cash for the purchase.
- D. Purchased a sewing machine for \$1,500 paying \$200 cash and signing a note for the balance.
- E. Finished a job for a customer earning \$180. The customer paid cash.
- F. Received a \$500 down payment to make a wedding dress.
- G. Received an electric bill for \$125 which is due to be paid in three weeks.
- H. Completed an altering job for \$45. The customer asked to be billed.

Prepare the necessary journal entries to record these transactions. If an entry is not required for any of these transactions, state this and explain why.

PA13. **L0** 3.5 George Hoskin started his own business, Hoskin Hauling. The following transactions occurred in the first two weeks:

- A. George Hoskin contributed cash of \$12,000 and a truck worth \$10,000 to start the business. He received Common Stock in return.
- B. Paid two months' rent in advance, \$800.
- C. Agreed to do a hauling job for a price of \$1,200.
- D. Performed the hauling job discussed in "C." We will get paid later.
- E. Received payment of \$600 on the hauling job done in "D."
- F. Purchased gasoline on credit, \$50.
- G. Performed another hauling job. Earned \$750, was paid cash.

Record the following transactions in T-accounts. Label each entry with the appropriate letter. Total the T-accounts when you are done.

PA14. **L0** 3.5 Prepare journal entries to record the following transactions. Create a T-account for Cash, post any entries that affect the account, and calculate the ending balance for the account. Assume a Cash beginning balance of \$16,333.

- A. February 2, issued stock to shareholders, for cash, \$25,000
- B. March 10, paid cash to purchase equipment, \$16,000

PA15. **L0 3.5** Prepare journal entries to record the following transactions. Create a T-account for Accounts Payable, post any entries that affect the account, and tally ending balance for the account. Assume an Accounts Payable beginning balance of \$5,000.

- A. February 2, purchased an asset, merchandise inventory, on account, \$30,000
- B. March 10, paid creditor for part of February purchase, \$12,000

PA16. **L0 3.5** Prepare journal entries to record the following transactions for the month of July:

- A. on first day of the month, paid rent for current month, \$2,000
- B. on tenth day of month, paid prior month balance due on accounts, \$3,100
- C. on twelfth day of month, collected cash for services provided, \$5,500
- D. on twenty-first day of month, paid salaries to employees, \$3,600
- E. on thirty-first day of month, paid for dividends to shareholders, \$800

PA17. **L0 3.5** Prepare journal entries to record the following transactions for the month of November:

- A. on first day of the month, issued common stock for cash, \$20,000
- B. on third day of month, purchased equipment for cash, \$10,500
- C. on tenth day of month, received cash for accounting services, \$14,250
- D. on fifteenth day of month, paid miscellaneous expenses, \$3,200
- E. on last day of month, paid employee salaries, \$8,600

PA18. **L0 3.5** Post the following July transactions to T-accounts for Accounts Receivable, Sales Revenue, and Cash, indicating the ending balance. Assume no beginning balances in these accounts.

- A. on first day of the month, sold products to customers for cash, \$13,660
- B. on fifth day of month, sold products to customers on account, \$22,100
- C. on tenth day of month, collected cash from customer accounts, \$18,500

PA19. **L0 3.5** Post the following November transactions to T-accounts for Accounts Payable, Inventory, and Cash, indicating the ending balance. Assume no beginning balances in Accounts Payable and Inventory, and a beginning Cash balance of \$36,500.

- A. purchased merchandise inventory on account, \$16,000
- B. paid vendors for part of inventory purchased earlier in month, \$12,000
- C. purchased merchandise inventory for cash, \$10,500

PA20. **L0 3.6** Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume accounts have normal balances.

Accounts payable	\$ 9,500
Accounts receivable	14,260
Cash	22,222
Common stock	30,000
Dividends	5,000
Equipment	12,000
Investments (short term)	25,444
Land	20,000
Notes payable	26,000
Retained earnings	12,815
Salaries expense	53,500
Service revenue	89,550
Supplies	2,750
Utility expense	12,689

PA21. **L0** 3.6 Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume all the accounts have normal balances.

Accounts payable	\$26,000
Accounts receivable	8,000
Cash	29,000
Common stock	33,000
Dividends	9,000
Equipment	68,000
Notes payable (due next month)	29,000
Salaries expense	42,000
Salaries payable	2,000
Service revenue	75,000
Supplies	5,000
Transportation expense	4,000



Problem Set B

PB1. **L0 3.2** Assuming the following account balances, what is the missing value?

Assets	\$1,150,000
Liabilities	588,000
Equity	?

PB2. **L0 3.2 L0 3.4** Assuming the following account balance changes for the period, what is the missing value?

Assets	\$ 73,000
Liabilities	33,000
Common stock	10,000
Dividends	5,000
Revenue	120,000
Expenses	?

PB3. **L0 3.2 L0 3.4** Assuming the following account balance changes for the period, what is the missing value?

Assets	?
Liabilities	\$110,500
Common stock	60,000
Dividends	15,000
Revenue	785,000
Expenses	234,750

PB4. **L0 3.2 L0 3.4** Identify the financial statement on which each of the following account categories would appear: the balance sheet (BS), the income statement (IS), or the retained earnings statement (RE).

	Financial statement	Normal balance
Accounts Receivable		
Automobile Expense		
Cash		
Equipment		
Notes Payable		
Service Revenue		

Table 3.21

PB5. **L0** 3.4 Indicate what impact (+ for increase; – for decrease) the following transactions would have on the accounting equation, $\text{Assets} = \text{Liabilities} + \text{Equity}$.

	Transaction	Impact 1	Impact 2
A.	Paid balance due for accounts payable		
B.	Charged clients for legal services provided		
C.	Purchased supplies on account		
D.	Collected legal service fees from clients for current month		
E.	Issued stock in exchange for a note receivable		

Table 3.22

PB6. **L0** 3.4 Indicate how changes in these types of accounts would be recorded (Dr for debit; Cr for credit).

		Debit or credit?
A.	Asset accounts	
B.	Liability accounts	
C.	Common Stock	
D.	Revenue	
E.	Expense	

Table 3.23

PB7. **L0** 3.4 Identify the normal balance (Dr for Debit; Cr for Credit) and type of account (A for asset, L for liability, E for equity, E-rev for revenue, E-exp for expense, and E-eq for equity) for each of the following accounts.

		Normal balance	Account type
A.	Utility Expense		
B.	Accounts Receivable		
C.	Interest Revenue		
D.	Retained Earnings		
E.	Land		
F.	Sales Revenue		

Table 3.24

PB8. **L0** 3.4 Indicate the net effect (+ for increase; – for decrease; 0 for no effect) of each of the following transactions on each part of the accounting equation, Assets = Liabilities + Equity. For example, for payment of an accounts payable balance, A (–) = L (–) + E (0).

- Payment of principal balance of note payable
- Purchase of supplies for cash
- Payment of dividends to stockholders
- Issuance of stock for cash
- Billing customer for physician services provided

PB9. **L0** 3.5 Prepare journal entries to record the following transactions. Create a T-account for Cash, post any entries that affect the account, and calculate the ending balance for the account. Assume a Cash beginning balance of \$37,400.

- May 12, collected balance due from customers on account, \$16,000
- June 10, purchased supplies for cash, \$4,444

PB10. **L0** 3.5 Prepare journal entries to record the following transactions. Create a T-account for Accounts Payable, post any entries that affect the account, and calculate the ending balance for the account. Assume an Accounts Payable beginning balance of \$7,500.

- May 12, purchased merchandise inventory on account. \$9,200
- June 10, paid creditor for part of previous month's purchase, \$11,350

PB11. **L0** 3.5 Prepare journal entries to record the following transactions that occurred in April:

- on first day of the month, issued common stock for cash, \$15,000
- on eighth day of month, purchased supplies, on account, \$1,800
- on twentieth day of month, billed customer for services provided, \$950
- on twenty-fifth day of month, paid salaries to employees, \$2,000
- on thirtieth day of month, paid for dividends to shareholders, \$500

PB12. L0 3.5 Prepare journal entries to record the following transactions that occurred in March:

- A. on first day of the month, purchased building for cash, \$75,000
- B. on fourth day of month, purchased inventory, on account, \$6,875
- C. on eleventh day of month, billed customer for services provided, \$8,390
- D. on nineteenth day of month, paid current month utility bill, \$2,000
- E. on last day of month, paid suppliers for previous purchases, \$2,850

PB13. L0 3.5 Post the following November transactions to T-accounts for Accounts Payable, Inventory, and Cash, indicating the ending balance. Assume no beginning balances in Accounts Payable and Inventory, and a beginning Cash balance of \$21,220.

- A. purchased merchandise inventory on account, \$9,900
- B. paid vendors for part of inventory purchased earlier in month, \$6,500
- C. purchased merchandise inventory for cash, \$4,750

PB14. L0 3.5 Post the following July transactions to T-accounts for Accounts Receivable, Sales Revenue, and Cash, indicating the ending balance. Assume no beginning balances in these accounts.

- A. sold products to customers for cash, \$7,500
- B. sold products to customers on account, \$12,650
- C. collected cash from customer accounts, \$9,500

PB15. L0 3.6 Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume all accounts have normal balances.

Accounts payable	\$ 3,600
Accounts receivable	45,333
Building	156,000
Cash	50,480
Common stock	110,000
Dividends	18,000
Equipment	33,500
Fees earned revenue	225,430
Land	18,000
Miscellaneous expense	5,123
Notes payable	85,500
Retained earnings	60,606
Salaries expense	151,900
Supplies	6,800

PB16. L0 3.6 Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume all accounts have normal balances.

Accounts payable	\$ 18,000
Accounts receivable	4,000
Automobile	28,000
Cash	19,000
Common stock	30,000
Dividends	16,000
Equipment	80,000
Insurance expense	8,000
Land	26,000
Notes payable (long term)	55,000
Salaries expense	37,000
Sales revenue	115,000

PB17. **L0 3.6** Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume all accounts have normal balances.

Accounts payable	\$ 3,600
Accounts receivable	45,333
Building	156,000
Cash	50,480
Common stock	110,000
Dividends	18,000
Equipment	33,500
Fees earned revenue	225,430
Land	18,000
Miscellaneous expense	5,123
Notes payable	85,500
Retained earnings	60,606
Salaries expense	151,900
Supplies	6,800

PB18. **L0 3.6** Prepare an unadjusted trial balance, in correct format, from the following alphabetized account information. Assume all accounts have normal balances.

Accounts payable	\$ 18,000
Accounts receivable	4,000
Automobile	28,000
Cash	19,000
Common stock	30,000
Dividends	16,000
Equipment	80,000
Insurance expense	8,000
Land	26,000
Notes payable (long term)	55,000
Salaries expense	37,000
Sales revenue	115,000



Thought Provokers

TP1. **L0 3.1** Is it possible to be too conservative? Explain your answer.

TP2. **L0 3.1** Why is it important to learn all of this terminology when accounting is a quantitative subject?

TP3. **L0 3.2** Assume that you are the controller of a business that provides legal services to clients. Suppose that the company has had a tough year, so the revenues have been lagging behind, based on previous years' standards. What would you do if your boss (the chief executive officer [CEO] of the company) asked to reclassify a transaction to report loan proceeds of \$150,000 as if the cash came from service fee revenue from clients instead. Would following the CEO's advice impact the company's accounting equation? How would reclassifying this one transaction change the outcome of the balance sheet, the income statement, and the statement of retained earnings? Would making this reclassification change the perception that users of the financial statements would have of the company's current year success and future year potential?

Write a memo, detailing your willingness (or not) to embrace this suggestion, giving reasons behind your decision. Remember to exercise diplomacy, even if you must dissent from the opinion of a supervisor. Note that the challenge of the assignment is to keep your integrity intact, while also keeping your job, if possible.

TP4. **L0** **3.2** Visit the website of the US Securities and Exchange Commission (SEC) (<https://www.sec.gov/edgar/searchedgar/companysearch.html>). Search for the latest Form 10-K for a company you would like to analyze. Submit a short memo that

- A. Includes the name and ticker symbol of the company you have chosen.
- B. Reviews the company's end-of-period Balance Sheet to determine the following:
 - i. total assets
 - ii. total liabilities
 - iii. total equity
- C. Presents the company's accounting equation at the end of the period, from the information you collected in (A), (B), and (C):
 - i. provide the web link to the company's Form 10-K to allow accurate verification of your answers

TP5. **L0** **3.3** Is the order in which we place information in the journal and ledger important?

TP6. **L0** **3.4** Visit the website of the SEC (<https://www.sec.gov/edgar/searchedgar/companysearch.html>). Search for the latest Form 10-K for a company you would like to analyze. Submit a short memo that

- A. Includes the name and ticker symbol of the company you have chosen
- B. Reviews the company's comparative Balance Sheet to gather the following information:
 - i. Compare beginning and ending Assets totals, noting amount of change for the most recent period
 - ii. Compare beginning and ending Liabilities totals, noting amount of change for the most recent period
 - iii. Compare beginning and ending Equity totals, noting amount of change for the most recent period
- C. State the changes identified in (A), (B), and (C) in accounting equation format. If the "change" equation does not balance, explain why not. Hint: Double-check your calculations, and if the accounting equation change still does not balance, search for notes in the company's files about prior period adjustments, which will often explain why balances may differ.
 - i. Provide the web link to the company's Form 10-K to allow accurate verification of your answers.

TP7. **L0** **3.5** Visit the website of the US Securities and Exchange Commission (SEC) (<https://www.sec.gov/edgar/searchedgar/companysearch.html>). Search for the latest Form 10-K for a company you would like to. When you are choosing, make sure the company sells a product (has inventory on the Balance Sheet, and Cost of Goods Sold on the Income Statement). Submit a short memo:

- A. Include the name and ticker symbol of the company you have chosen.
- B. Follow the financial statement progression from the Income Statement to the Retained Earnings Statement to the Balance Sheet. Find the net income amount from the Income Statement and identify where it appears on the Statement of Retained Earnings (or the Statement of Stockholders' Equity).
- C. On the statement found for instruction (A), find the ending retained earnings balance, and identify where it appears on the Balance Sheet for year-end.
- D. Provide the web link to the company's Form 10-K to allow accurate verification of your answers.

TP8. LO 3.6 Analyze Trusty Company's trial balance and the additional information provided to determine the following:

- A. what is causing the trial balance to be out of balance
- B. any other errors that require corrections that are identified during your analysis
- C. the effect (if any) that correcting the errors will have on the accounting equation

TRUSTY COMPANY Trial Balance For the Month Ended December 31, 2018		
	Debit	Credit
Cash	\$ 77,500	
Accounts receivable	5,600	
Supplies	2,450	
Equipment	11,200	
Accounts payable		\$ 17,000
Notes payable		27,400
Common stock		20,000
Retained earnings		7,900
Dividends	6,000	
Service revenue		99,300
Advertising expense	4,350	
Salaries expense	46,500	
	<u>\$153,600</u>	<u>\$171,600</u>

A review of transactions revealed the following facts:

- A service fee of \$18,000 was earned (but not yet collected) by the end of the period but was accidentally not recorded as revenue at that time.
- A transposition error occurred when transferring the account balances from the ledger to the trial balance. Salaries expense should have been listed on the trial balance as \$64,500 but was inadvertently recorded as \$46,500.
- Two machines that cost \$9,000 each were purchased on account but were not recorded in company accounting records.

The Adjustment Process

Figure 4.1 Mark's Dry-Cleaning Business. (credit: modification of "Dry Cleaning" by Donald West/Flickr, CC BY 2.0)

Chapter Outline

- LO 4.1** Explain the Concepts and Guidelines Affecting Adjusting Entries
- LO 4.2** Discuss the Adjustment Process and Illustrate Common Types of Adjusting Entries
- LO 4.3** Record and Post the Common Types of Adjusting Entries
- LO 4.4** Use the Ledger Balances to Prepare an Adjusted Trial Balance
- LO 4.5** Prepare Financial Statements Using the Adjusted Trial Balance



Why It Matters

As we learned in [Analyzing and Recording Transactions](#), upon finishing college Mark Summers wanted to start his own dry-cleaning business called Supreme Cleaners. After four years, Mark finished college and opened Supreme Cleaners. During his first month of operations, Mark purchased dry-cleaning equipment and supplies. He also hired an employee, opened a savings account, and provided services to his first customers, among other things.

Mark kept thorough records of all of the daily business transactions for the month. At the end of the month, Mark reviewed his trial balance and realized that some of the information was not up to date. His equipment and supplies had been used, making them less valuable. He had not yet paid his employee for work completed. His business savings account earned interest. Some of his customers had paid in advance for their dry cleaning, with Mark's business providing the service during the month.

What should Mark do with all of these events? Does he have a responsibility to record these transactions? If so, how would he go about recording this information? How does it affect his financial statements? Mark will

have to explore his accounting process to determine if these end-of-period transactions require recording and adjust his financial statements accordingly. This exploration is performed by taking the next few steps in the *accounting cycle*.

4.1 Explain the Concepts and Guidelines Affecting Adjusting Entries

[Analyzing and Recording Transactions](#) was the first of three consecutive chapters covering the steps in the accounting cycle ([Figure 4.2](#)).

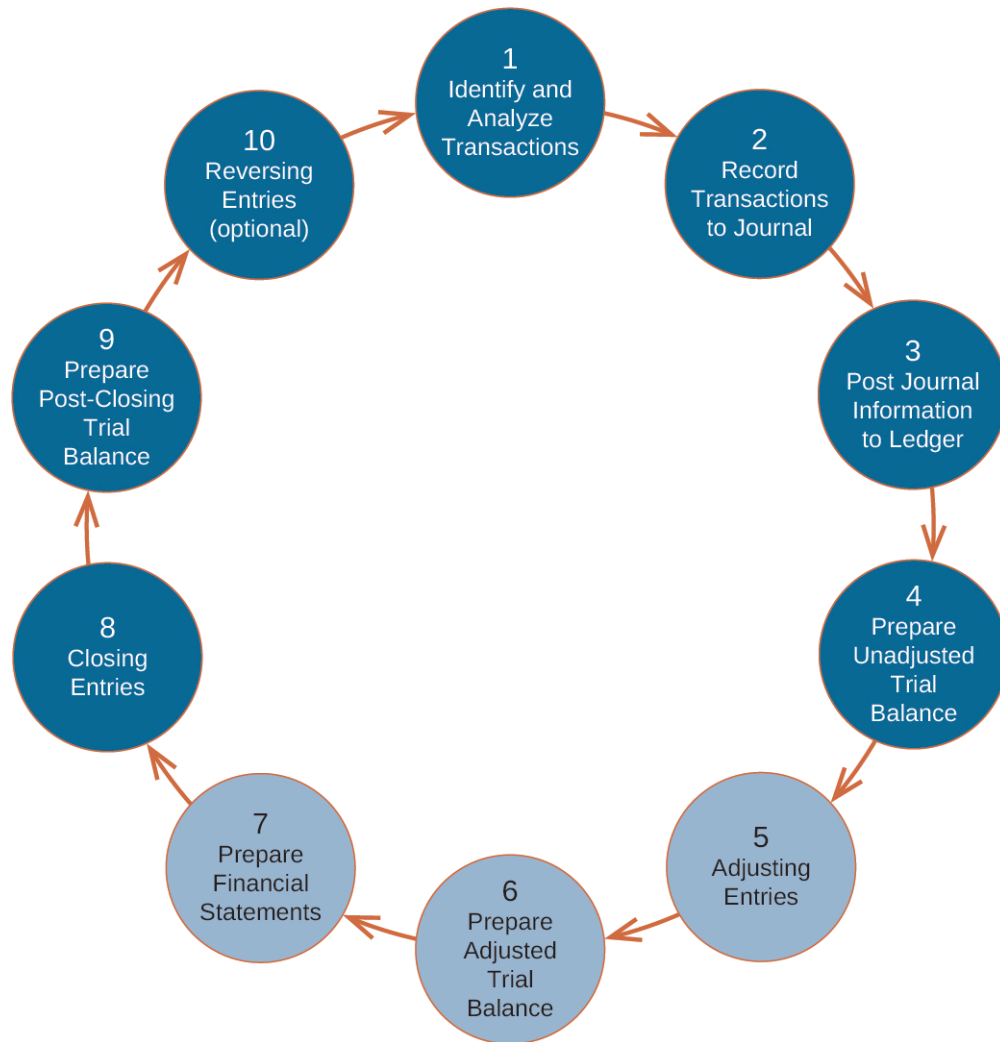


Figure 4.2 The Basic Accounting Cycle. In this chapter, we examine the next three steps in the accounting cycle—5, 6, and 7—which cover adjusting entries (journalize and post), preparing an adjusted trial balance, and preparing the financial statements. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

In [Analyzing and Recording Transactions](#), we discussed the first four steps in the accounting cycle: identify and analyze transactions, record transactions to a journal, post journal information to the general ledger, and prepare an (unadjusted) trial balance. This chapter examines the next three steps in the cycle: record adjusting entries (journalizing and posting), prepare an adjusted trial balance, and prepare the financial statements ([Figure 4.3](#)).

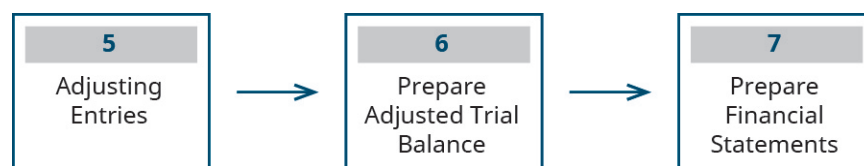


Figure 4.3 Steps 5, 6, and 7 in the Accounting Cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

As we progress through these steps, you learn why the trial balance in this phase of the accounting cycle is referred to as an “adjusted” trial balance. We also discuss the purpose of adjusting entries and the accounting concepts supporting their need. One of the first concepts we discuss is accrual accounting.

Accrual Accounting

Public companies reporting their financial positions use either US generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS), as allowed under the Securities and Exchange Commission (SEC) regulations. Also, companies, public or private, using US GAAP or IFRS prepare their financial statements using the rules of accrual accounting. Recall from [Introduction to Financial Statements](#) that accrual basis accounting prescribes that revenues and expenses must be recorded in the accounting period in which they were earned or incurred, no matter when cash receipts or payments occur. It is because of accrual accounting that we have the *revenue recognition principle* and the *expense recognition principle* (also known as the *matching principle*).

The accrual method is considered to better match revenues and expenses and standardizes reporting information for comparability purposes. Having comparable information is important to external users of information trying to make investment or lending decisions, and to internal users trying to make decisions about company performance, budgeting, and growth strategies.

Some nonpublic companies may choose to use cash basis accounting rather than accrual basis accounting to report financial information. Recall from [Introduction to Financial Statements](#) that cash basis accounting is a method of accounting in which transactions are not recorded in the financial statements until there is an exchange of cash. Cash basis accounting sometimes delays or accelerates revenue and expense reporting until cash receipts or outlays occur. With this method, cash flows are used to measure business performance in a given period and can be simpler to track than accrual basis accounting.

There are several other accounting methods or concepts that accountants will sometimes apply. The first is **modified accrual accounting**, which is commonly used in governmental accounting and merges accrual basis and cash basis accounting. The second is **tax basis accounting** that is used in establishing the tax effects of transactions in determining the tax liability of an organization.

One fundamental concept to consider related to the accounting cycle—and to accrual accounting in particular—is the idea of the accounting period.

The Accounting Period

As we discussed, accrual accounting requires companies to report revenues and expenses in the accounting period in which they were earned or incurred. An **accounting period** breaks down company financial information into specific time spans, and can cover a month, a quarter, a half-year, or a full year. Public companies governed by GAAP are required to present quarterly (three-month) accounting period financial

statements called 10-Qs. However, most public and private companies keep monthly, quarterly, and yearly (annual) period information. This is useful to users needing up-to-date financial data to make decisions about company investment and growth. When the company keeps yearly information, the year could be based on a fiscal or calendar year. This is explained shortly.

CONTINUING APPLICATION AT WORK

Adjustment Process for Grocery Stores

In every industry, adjustment entries are made at the end of the period to ensure revenue matches expenses. Companies with an online presence need to account for items sold that have not yet been shipped or are in the process of reaching the end user. But what about the grocery industry? At first glance, it might seem that no such adjustment entries are necessary. However, grocery stores have adapted to the current retail environment. For example, your local grocery store might provide catering services for a graduation party. If the contract requires the customer to put down a 50% deposit, and occurs near the end of a period, the grocery store will have unearned revenue until it provides the catering service. Once the party occurs, the grocery store needs to make an adjusting entry to reflect that revenue has been earned.

The Fiscal Year and the Calendar Year

A company may choose its yearly reporting period to be based on a calendar or fiscal year. If a company uses a **calendar year**, it is reporting financial data from January 1 to December 31 of a specific year. This may be useful for businesses needing to coincide with a traditional yearly tax schedule. It can also be easier to track for some businesses without formal reconciliation practices, and for small businesses.

A **fiscal year** is a twelve-month reporting cycle that can begin in any month and records financial data for that consecutive twelve-month period. For example, a business may choose its fiscal year to begin on April 1, 2019, and end on March 31, 2020. This can be common practice for corporations and may best reflect the operational flow of revenues and expenses for a particular business. In addition to annual reporting, companies often need or choose to report financial statement information in interim periods.

Interim Periods

An **interim period** is any reporting period shorter than a full year (fiscal or calendar). This can encompass monthly, quarterly, or half-year statements. The information contained on these statements is timelier than waiting for a yearly accounting period to end. The most common interim period is three months, or a quarter. For companies whose common stock is traded on a major stock exchange, meaning these are *publicly traded* companies, quarterly statements must be filed with the SEC on a Form 10-Q. The companies must file a Form 10-K for their annual statements. As you've learned, the SEC is an independent agency of the federal government that provides oversight of public companies to maintain fair representation of company financial activities for investors to make informed decisions.

In order for information to be useful to the user, it must be timely—that is, the user has to get it quickly enough so it is relevant to decision-making. You may recall from [Analyzing and Recording Transactions](#) that

this is the basis of the time period assumption in accounting. For example, a potential or existing investor wants timely information by which to measure the performance of the company, and to help decide whether to invest, to stay invested, or to sell their stockholdings and invest elsewhere. This requires companies to organize their information and break it down into shorter periods. Internal and external users can then rely on the information that is both timely and relevant to decision-making.

The accounting period a company chooses to use for financial reporting will impact the types of adjustments they may have to make to certain accounts.

ETHICAL CONSIDERATIONS

Illegal Cookie Jar Accounting Used to Manage Earnings

From 2000 through the end of 2001, **Bristol-Myers Squibb** engaged in “Cookie Jar Accounting,” resulting in \$150 million in SEC fines. The company manipulated its accounting to create a false indication of income and growth to create the appearance that it was meeting its own targets and Wall Street analysts’ earnings estimates during the years 2000 and 2001. The SEC describes some of what occurred:

Bristol-Myers inflated its results primarily by (1) stuffing its distribution channels with excess inventory near the end of every quarter in amounts sufficient to meet its targets by making pharmaceutical sales to its wholesalers ahead of demand; and (2) improperly recognizing \$1.5 billion in revenue from such pharmaceutical sales to its two biggest wholesalers. In connection with the \$1.5 billion in revenue, Bristol-Myers covered these wholesalers’ carrying costs and guaranteed them a return on investment until they sold the products. When Bristol-Myers recognized the \$1.5 billion in revenue upon shipment, it did so contrary to generally accepted accounting principles.^[1]

In addition to the improper distribution of product to manipulate earnings numbers, which was not enough to meet earnings targets, the company improperly used divestiture reserve funds (a “cookie jar” fund that is funded by the sale of assets such as product lines or divisions) to meet those targets. In this circumstance, earnings management was considered illegal, costing the company millions of dollars in fines.

4.2 Discuss the Adjustment Process and Illustrate Common Types of Adjusting Entries

When a company reaches the end of a period, it must update certain accounts that have either been left unattended throughout the period or have not yet been recognized. **Adjusting entries** update accounting records at the end of a period for any transactions that have not yet been recorded. One important accounting principle to remember is that just as the accounting equation (Assets = Liabilities + Owner’s equity/or common stock/or capital) must be equal, it must remain equal after you make adjusting entries. Also note that in this equation, owner’s equity represents an individual owner (sole proprietorship), common stock represents a corporation’s owners’ interests, and capital represents a partnership’s owners’ interests. We discuss the effects of adjusting entries in greater detail throughout this chapter.

1 U.S. Securities and Exchange Commission. “Bristol-Myers Squibb Company Agrees to Pay \$150 Million to Settle Fraud Charges.” August 4, 2004. <https://www.sec.gov/news/press/2004-105.htm>

There are several steps in the accounting cycle that require the preparation of a trial balance: step 4, preparing an unadjusted trial balance; step 6, preparing an adjusted trial balance; and step 9, preparing a post-closing trial balance. You might question the purpose of more than one trial balance. For example, why can we not go from the unadjusted trial balance straight into preparing financial statements for public consumption? What is the purpose of the adjusted trial balance? Does preparing more than one trial balance mean the company made a mistake earlier in the accounting cycle? To answer these questions, let's first explore the (unadjusted) trial balance, and why some accounts have incorrect balances.

Why Some Accounts Have Incorrect Balances on the Trial Balance

The unadjusted trial balance may have incorrect balances in some accounts. Recall the trial balance from [Analyzing and Recording Transactions](#) for the example company, Printing Plus.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		<u>9,500</u>
Salaries Expense	3,600	
Utility Expense	<u>300</u>	
Total	<u>\$34,000</u>	<u>\$34,000</u>

Figure 4.4 Unadjusted Trial Balance for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The trial balance for Printing Plus shows Supplies of \$500, which were purchased on January 30. Since this is a new company, Printing Plus would more than likely use some of their supplies right away, before the end of the month on January 31. Supplies are only an asset when they are unused. If Printing Plus used some of its supplies immediately on January 30, then why is the full \$500 still in the supply account on January 31? How do we fix this incorrect balance?

Similarly, what about Unearned Revenue? On January 9, the company received \$4,000 from a customer for printing services to be performed. The company recorded this as a liability because it received payment without providing the service. To clear this liability, the company must perform the service. Assume that as of January 31 some of the printing services have been provided. Is the full \$4,000 still a liability? Since a portion of the service was provided, a change to unearned revenue should occur. The company needs to correct this balance in the Unearned Revenue account.

Having incorrect balances in Supplies and in Unearned Revenue on the company's January 31 trial balance is not due to any error on the company's part. The company followed all of the correct steps of the accounting cycle up to this point. So why are the balances still incorrect?

Journal entries are recorded when an activity or event occurs that triggers the entry. Usually the trigger is from an original source. Recall that an original source can be a formal document substantiating a transaction, such as an invoice, purchase order, cancelled check, or employee time sheet. Not every transaction produces an original source document that will alert the bookkeeper that it is time to make an entry.

When a company purchases supplies, the original order, receipt of the supplies, and receipt of the invoice from the vendor will all trigger journal entries. This trigger does not occur when using supplies from the supply closet. Similarly, for unearned revenue, when the company receives an advance payment from the customer for services yet provided, the cash received will trigger a journal entry. When the company provides the printing services for the customer, the customer will not send the company a reminder that revenue has now been earned. Situations such as these are why businesses need to make adjusting entries.

THINK IT THROUGH

Keep Calm and Adjust . . .

Elliot Simmons owns a small law firm. He does the accounting himself and uses an accrual basis for accounting. At the end of his first month, he reviews his records and realizes there are a few inaccuracies on this unadjusted trial balance.

One difference is the supplies account; the figure on paper does not match the value of the supplies inventory still available. Another difference was interest earned from his bank account. He did not have anything recognizing these earnings.

Why did his unadjusted trial balance have these errors? What can be attributed to the differences in supply figures? What can be attributed to the differences in interest earned?

The Need for Adjusting Entries

Adjusting entries update accounting records at the end of a period for any transactions that have not yet been recorded. These entries are necessary to ensure the income statement and balance sheet present the correct, up-to-date numbers. Adjusting entries are also necessary because the initial trial balance may not contain complete and current data due to several factors:

- The inefficiency of recording every single day-to-day event, such as the use of supplies.
- Some costs are not recorded during the period but must be recognized at the end of the period, such as depreciation, rent, and insurance.
- Some items are forthcoming for which original source documents have not yet been received, such as a utility bill.

There are a few other guidelines that support the need for adjusting entries.

Guidelines Supporting Adjusting Entries

Several guidelines support the need for adjusting entries:

- Revenue recognition principle: Adjusting entries are necessary because the revenue recognition principle

requires revenue recognition when earned, thus the need for an update to unearned revenues.

- Expense recognition (matching) principle: This requires matching expenses incurred to generate the revenues earned, which affects accounts such as insurance expense and supplies expense.
- Time period assumption: This requires useful information be presented in shorter time periods such as years, quarters, or months. This means a company must recognize revenues and expenses in the proper period, requiring adjustment to certain accounts to meet these criteria.

The required adjusting entries depend on what types of transactions the company has, but there are some common types of adjusting entries. Before we look at recording and posting the most common types of adjusting entries, we briefly discuss the various types of adjusting entries.

Types of Adjusting Entries

Adjusting entries requires updates to specific account types at the end of the period. Not all accounts require updates, only those not naturally triggered by an original source document. There are two main types of adjusting entries that we explore further, deferrals and accruals.

Deferrals

Deferrals are prepaid expense and revenue accounts that have delayed recognition until they have been used or earned. This recognition may not occur until the end of a period or future periods. When deferred expenses and revenues have yet to be recognized, their information is stored on the balance sheet. As soon as the expense is incurred and the revenue is earned, the information is transferred from the balance sheet to the income statement. Two main types of deferrals are prepaid expenses and unearned revenues.

Prepaid Expenses

Recall from [Analyzing and Recording Transactions](#) that *prepaid expenses* (prepayments) are assets for which advanced payment has occurred, before the company can benefit from use. As soon as the asset has provided benefit to the company, the value of the asset used is transferred from the balance sheet to the income statement as an expense. Some common examples of prepaid expenses are supplies, depreciation, insurance, and rent.

When a company purchases supplies, it may not use all supplies immediately, but chances are the company has used some of the supplies by the end of the period. It is not worth it to record every time someone uses a pencil or piece of paper during the period, so at the end of the period, this account needs to be updated for the value of what has been used.

Let's say a company paid for supplies with cash in the amount of \$400. At the end of the month, the company took an inventory of supplies used and determined the value of those supplies used during the period to be \$150. The following entry occurs for the initial payment.

JOURNAL			
Date	Account	Debit	Credit
	Supplies	400	
	Cash		400
	<i>To recognize purchase of supplies</i>		

Supplies increases (debit) for \$400, and Cash decreases (credit) for \$400. When the company recognizes the supplies usage, the following adjusting entry occurs.

JOURNAL			
Date	Account	Debit	Credit
	Supplies Expense Supplies <i>To recognize supplies used during the period</i>	150	150

Supplies Expense is an expense account, increasing (debit) for \$150, and Supplies is an asset account, decreasing (credit) for \$150. This means \$150 is transferred from the balance sheet (asset) to the income statement (expense). Notice that not all of the supplies are used. There is still a balance of \$250 ($400 - 150$) in the Supplies account. This amount will carry over to future periods until used. The balances in the Supplies and Supplies Expense accounts show as follows.

Supplies		Salaries Expense	
400	150	150	
Bal. 250		Bal. 150	

Depreciation may also require an adjustment at the end of the period. Recall that *depreciation* is the systematic method to record the allocation of cost over a given period of certain assets. This allocation of cost is recorded over the **useful life** of the asset, or the time period over which an asset cost is allocated. The allocated cost up to that point is recorded in Accumulated Depreciation, a contra asset account. A **contra account** is an account paired with another account type, has an opposite normal balance to the paired account, and reduces the balance in the paired account at the end of a period.

Accumulated Depreciation is contrary to an asset account, such as Equipment. This means that the normal balance for Accumulated Depreciation is on the credit side. It houses all depreciation expensed in current and prior periods. Accumulated Depreciation will reduce the asset account for depreciation incurred up to that point. The difference between the asset's value (cost) and accumulated depreciation is called the **book value** of the asset. When depreciation is recorded in an adjusting entry, Accumulated Depreciation is credited and Depreciation Expense is debited.

For example, let's say a company pays \$2,000 for equipment that is supposed to last four years. The company wants to depreciate the asset over those four years equally. This means the asset will lose \$500 in value each year ($\$2,000/\text{four years}$). In the first year, the company would record the following adjusting entry to show depreciation of the equipment.

JOURNAL			
Date	Account	Debit	Credit
	Depreciation Expense Accumulated Depreciation: Equipment <i>To recognize depreciation for the year</i>	500	500

Depreciation Expense increases (debit) and Accumulated Depreciation, Equipment, increases (credit). If the company wanted to compute the book value, it would take the original cost of the equipment and subtract accumulated depreciation.

$$\text{Book value of equipment} = \$2,000 - \$500 = \$1,500$$

This means that the current book value of the equipment is \$1,500, and depreciation will be subtracted from this figure the next year. The following account balances after adjustment are as follows:

Accumulated Depreciation: Equipment		Depreciation Expense	
	500		500
	Bal. 500		Bal. 500

You will learn more about depreciation and its computation in [Long-Term Assets](#). However, one important fact that we need to address now is that the book value of an asset is not necessarily the price at which the asset would sell. For example, you might have a building for which you paid \$1,000,000 that currently has been depreciated to a book value of \$800,000. However, today it could sell for more than, less than, or the same as its book value. The same is true about just about any asset you can name, except, perhaps, cash itself.

Insurance policies can require advanced payment of fees for several months at a time, six months, for example. The company does not use all six months of insurance immediately but over the course of the six months. At the end of each month, the company needs to record the amount of insurance expired during that month.

For example, a company pays \$4,500 for an insurance policy covering six months. It is the end of the first month and the company needs to record an adjusting entry to recognize the insurance used during the month. The following entries show the initial payment for the policy and the subsequent adjusting entry for one month of insurance usage.

JOURNAL			
Date	Account	Debit	Credit
	Prepaid Insurance Cash <i>To recognize payment for insurance policy covering six months</i>	4,500	4,500
	Insurance Expense Prepaid Insurance <i>To recognize insurance used during one month</i>	750	750

In the first entry, Cash decreases (credit) and Prepaid Insurance increases (debit) for \$4,500. In the second entry, Prepaid Insurance decreases (credit) and Insurance Expense increases (debit) for one month's insurance usage found by taking the total \$4,500 and dividing by six months ($4,500/6 = 750$). The account balances after adjustment are as follows:

Prepaid Insurance		Insurance Expense	
4,500	750	750	
Bal. 3,750		Bal. 750	

Similar to prepaid insurance, rent also requires advanced payment. Usually to rent a space, a company will need to pay rent at the beginning of the month. The company may also enter into a lease agreement that requires several months, or years, of rent in advance. Each month that passes, the company needs to record

rent used for the month.

Let's say a company pays \$8,000 in advance for four months of rent. After the first month, the company records an adjusting entry for the rent used. The following entries show initial payment for four months of rent and the adjusting entry for one month's usage.

JOURNAL			
Date	Account	Debit	Credit
	Prepaid Rent Cash <i>To recognize payment for rent covering four months</i>	8,000	8,000
	Rent Expense Prepaid Rent <i>To recognize rent used during one month</i>	2,000	2,000

In the first entry, Cash decreases (credit) and Prepaid Rent increases (debit) for \$8,000. In the second entry, Prepaid Rent decreases (credit) and Rent Expense increases (debit) for one month's rent usage found by taking the total \$8,000 and dividing by four months ($8,000/4 = 2,000$). The account balances after adjustment are as follows:

Prepaid Rent		Rent Expense	
8,000	2,000	2,000	
Bal. 6,000		Bal. 2,000	

Another type of deferral requiring adjustment is unearned revenue.

Unearned Revenues

Recall that unearned revenue represents a customer's advanced payment for a product or service that has yet to be provided by the company. Since the company has not yet provided the product or service, it cannot recognize the customer's payment as revenue. At the end of a period, the company will review the account to see if any of the unearned revenue has been earned. If so, this amount will be recorded as revenue in the current period.

For example, let's say the company is a law firm. During the year, it collected retainer fees totaling \$48,000 from clients. Retainer fees are money lawyers collect in advance of starting work on a case. When the company collects this money from its clients, it will debit cash and credit unearned fees. Even though not all of the \$48,000 was probably collected on the same day, we record it as if it was for simplicity's sake.

JOURNAL			
Date	Account	Debit	Credit
	Cash Unearned Fee Revenue <i>To recognize collection of retainer fees</i>	48,000	48,000

In this case, Unearned Fee Revenue increases (credit) and Cash increases (debit) for \$48,000.

At the end of the year after analyzing the unearned fees account, 40% of the unearned fees have been earned.

This 40% can now be recorded as revenue. Total revenue recorded is \$19,200 ($\$48,000 \times 40\%$).

JOURNAL			
Date	Account	Debit	Credit
	Unearned Fee Revenue Fee Revenue <i>To recognize fees earned</i>	19,200	19,200

For this entry, Unearned Fee Revenue decreases (debit) and Fee Revenue increases (credit) for \$19,200, which is the 40% earned during the year. The company will have the following balances in the two accounts:

Unearned Fee Revenue		Fee Revenue	
19,200	48,000	19,200	
	Bal. 28,800		Bal. 19,200

Besides deferrals, other types of adjusting entries include accruals.

Accruals

Accruals are types of adjusting entries that accumulate during a period, where amounts were previously unrecorded. The two specific types of adjustments are accrued revenues and accrued expenses.

Accrued Revenues

Accrued revenues are revenues earned in a period but have yet to be recorded, and no money has been collected. Some examples include interest, and services completed but a bill has yet to be sent to the customer.

Interest can be earned from bank account holdings, notes receivable, and some accounts receivables (depending on the contract). Interest had been accumulating during the period and needs to be adjusted to reflect interest earned at the end of the period. Note that this interest has not been paid at the end of the period, only earned. This aligns with the revenue recognition principle to recognize revenue when earned, even if cash has yet to be collected.

For example, assume that a company has one outstanding note receivable in the amount of \$100,000. Interest on this note is 5% per year. Three months have passed, and the company needs to record interest earned on this outstanding loan. The calculation for the interest revenue earned is $\$100,000 \times 5\% \times 3/12 = \$1,250$. The following adjusting entry occurs.

JOURNAL			
Date	Account	Debit	Credit
	Interest Receivable Interest Revenue <i>To recognize interest revenue earned and due</i>	1,250	1,250

Interest Receivable increases (debit) for \$1,250 because interest has not yet been paid. Interest Revenue increases (credit) for \$1,250 because interest was earned in the three-month period but had been previously unrecorded.

Interest Receivable		Interest Revenue	
	1,250		1,250
	Bal. 1,250		Bal. 1,250

Previously unrecorded service revenue can arise when a company provides a service but did not yet bill the client for the work. This means the customer has also not yet paid for services. Since there was no bill to trigger a transaction, an adjustment is required to recognize revenue earned at the end of the period.

For example, a company performs landscaping services in the amount of \$1,500. However, they have not yet received payment. At the period end, the company would record the following adjusting entry.

JOURNAL			
Date	Account	Debit	Credit
	Accounts Receivable Service Revenue <i>To recognize service revenue earned and due</i>	1,500	1,500

Accounts Receivable increases (debit) for \$1,500 because the customer has not yet paid for services completed. Service Revenue increases (credit) for \$1,500 because service revenue was earned but had been previously unrecorded.

Service Revenue		Accounts Receivable	
	1,500	1,500	
	Bal. 1,500	Bal. 1,500	

Accrued Expenses

Accrued expenses are expenses incurred in a period but have yet to be recorded, and no money has been paid. Some examples include interest, tax, and salary expenses.

Interest expense arises from notes payable and other loan agreements. The company has accumulated interest during the period but has not recorded or paid the amount. This creates a liability that the company must pay at a future date. You cover more details about computing interest in [Current Liabilities](#), so for now amounts are given.

For example, a company accrued \$300 of interest during the period. The following entry occurs at the end of the period.

JOURNAL			
Date	Account	Debit	Credit
	Interest Expense Interest Payable <i>To recognize interest expense incurred but not paid</i>	300	300

Interest Expense increases (debit) and Interest Payable increases (credit) for \$300. The following are the updated ledger balances after posting the adjusting entry.

Interest Payable		Interest Expense	
	300	300	
	Bal. 300	Bal. 300	

Taxes are only paid at certain times during the year, not necessarily every month. Taxes the company owes during a period that are unpaid require adjustment at the end of a period. This creates a liability for the company. Some tax expense examples are income and sales taxes.

For example, a company has accrued income taxes for the month for \$9,000. The company would record the following adjusting entry.

JOURNAL			
Date	Account	Debit	Credit
	Income Tax Expense Income Tax Payable <i>To recognize income tax expense incurred but not paid</i>	9,000	9,000

Income Tax Expense increases (debit) and Income Tax Payable increases (credit) for \$9,000. The following are the updated ledger balances after posting the adjusting entry.

Income Tax Payable		Income Tax Expense	
	9,000	9,000	
	Bal. 9,000	Bal. 9,000	

Many salaried employees are paid once a month. The salary the employee earned during the month might not be paid until the following month. For example, the employee is paid for the prior month's work on the first of the next month. The financial statements must remain up to date, so an adjusting entry is needed during the month to show salaries previously unrecorded and unpaid at the end of the month.

Let's say a company has five salaried employees, each earning \$2,500 per month. In our example, assume that they do not get paid for this work until the first of the next month. The following is the adjusting journal entry for salaries.

JOURNAL			
Date	Account	Debit	Credit
	Salaries Expense Salaries Payable <i>To recognize salaries expense incurred but not paid</i>	12,500	12,500

Salaries Expense increases (debit) and Salaries Payable increases (credit) for \$12,500 (\$2,500 per employee × five employees). The following are the updated ledger balances after posting the adjusting entry.

Salaries Payable		Salaries Expense	
	12,500	12,500	
	Bal. 12,500	Bal. 12,500	

In [Record and Post the Common Types of Adjusting Entries](#), we explore some of these adjustments specifically for our company Printing Plus, and show how these entries affect our general ledger (T-accounts).

YOUR TURN

Adjusting Entries

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?

Table 4.1

Review the three adjusting entries that follow. Using the table provided, for each entry write down the income statement account and balance sheet account used in the adjusting entry in the appropriate column. Then in the last column answer yes or no.

	Supplies Expense Supplies	500	500
	Unearned Revenue Service Revenue	2,000	2,000
	Rent Expense Prepaid Machine Rent	1,200	1,200

Solution

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?
1	Supplies expense	Supplies	no
2	Service Revenue	Unearned Revenue	no

Table 4.2

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?
3	Rent Expense	Prepaid machine rent	no

Table 4.2

YOUR TURN

Adjusting Entries Take Two

Did we continue to follow the rules of adjusting entries in these two examples? Explain.

	Electricity Expense Accounts Payable	100	100
	Salaries Expense Salaries Payable	4,000	4,000

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?

Table 4.3

Solution

Yes, we did. Each entry has one income statement account and one balance sheet account, and cash does not appear in either of the adjusting entries.

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?
1	Electricity Expense	Accounts Payable	no
2	Salaries Expense	Salaries Payable	no

Table 4.4

4.3 Record and Post the Common Types of Adjusting Entries

Before beginning adjusting entry examples for Printing Plus, let's consider some rules governing adjusting entries:

- Every adjusting entry will have at least one income statement account and one balance sheet account.
- Cash will never be in an adjusting entry.
- The adjusting entry records the change in amount that occurred during the period.

What are "income statement" and "balance sheet" accounts? Income statement accounts include revenues and expenses. Balance sheet accounts are assets, liabilities, and stockholders' equity accounts, since they appear on a balance sheet. The second rule tells us that cash can never be in an adjusting entry. This is true because paying or receiving cash triggers a journal entry. This means that every transaction with cash will be recorded at the time of the exchange. We will not get to the adjusting entries and have cash paid or received which has not already been recorded. If accountants find themselves in a situation where the cash account must be adjusted, the necessary adjustment to cash will be a *correcting entry* and not an adjusting entry.

With an adjusting entry, the amount of change occurring during the period is recorded. For example, if the supplies account had a \$300 balance at the beginning of the month and \$100 is still available in the supplies account at the end of the month, the company would record an adjusting entry for the \$200 used during the month ($300 - 100$). Similarly for unearned revenues, the company would record how much of the revenue was earned during the period.

Let's now consider new transaction information for Printing Plus.

CONCEPTS IN PRACTICE

Earnings Management

Recording adjusting entries seems so cut and dry. It looks like you just follow the rules and all of the numbers come out 100 percent correct on all financial statements. But in reality this is not always the case. Just the fact that you have to make estimates in some cases, such as depreciation estimating residual value and useful life, tells you that numbers will not be 100 percent correct unless the accountant has ESP. Some companies engage in something called earnings management, where they follow the rules of accounting mostly but they stretch the truth a little to make it look like they are more profitable. Some companies do this by recording revenue before they should. Others leave assets on the books instead of expensing them when they should to decrease total expenses and increase profit.

Take Mexico-based home-building company **Desarrolladora Homex S.A.B. de C.V.** This company reported revenue earned on more than 100,000 homes they had not even build yet. The SEC's complaint states that Homex reported revenues from a project site where every planned home was said to have been "built and sold by Dec. 31, 2011. Satellite images of the project site on March 12, 2012, show it was still largely undeveloped and the vast majority of supposedly sold homes remained unbuilt."^[2]

Is managing your earnings illegal? In some situations it is just an unethical stretch of the truth easy enough to do because of the estimates made in adjusting entries. You can simply change your estimate and insist the new estimate is really better when maybe it is your way to improve the bottom line, for example, changing your annual depreciation expense calculated on expensive plant assets from assuming a ten-year useful life, a reasonable estimated expectation, to a twenty-year useful life, not so

reasonable but you insist your company will be able to use these assets twenty years while knowing that is a slim possibility. Doubling the useful life will cause 50% of the depreciation expense you would have had. This will make a positive impact on net income. This method of earnings management would probably not be considered illegal but is definitely a breach of ethics. In other situations, companies manage their earnings in a way that the SEC believes is actual fraud and charges the company with the illegal activity.

Recording Common Types of Adjusting Entries

Recall the transactions for Printing Plus discussed in [Analyzing and Recording Transactions](#).

Jan. 3, 2019	issues \$20,000 shares of common stock for cash
Jan. 5, 2019	purchases equipment on account for \$3,500, payment due within the month
Jan. 9, 2019	receives \$4,000 cash in advance from a customer for services not yet rendered
Jan. 10, 2019	provides \$5,500 in services to a customer who asks to be billed for the services
Jan. 12, 2019	pays a \$300 utility bill with cash
Jan. 14, 2019	distributed \$100 cash in dividends to stockholders
Jan. 17, 2019	receives \$2,800 cash from a customer for services rendered
Jan. 18, 2019	paid in full, with cash, for the equipment purchase on January 5
Jan. 20, 2019	paid \$3,600 cash in salaries expense to employees
Jan. 23, 2019	received cash payment in full from the customer on the January 10 transaction
Jan. 27, 2019	provides \$1,200 in services to a customer who asks to be billed for the services
Jan. 30, 2019	purchases supplies on account for \$500, payment due within three months

On January 31, 2019, Printing Plus makes adjusting entries for the following transactions.

1. On January 31, Printing Plus took an inventory of its supplies and discovered that \$100 of supplies had been used during the month.
2. The equipment purchased on January 5 depreciated \$75 during the month of January.
3. Printing Plus performed \$600 of services during January for the customer from the January 9 transaction.
4. Reviewing the company bank statement, Printing Plus discovers \$140 of interest earned during the month of January that was previously uncollected and unrecorded.
5. Employees earned \$1,500 in salaries for the period of January 21–January 31 that had been previously unpaid and unrecorded.

We now record the adjusting entries from January 31, 2019, for Printing Plus.

Transaction 13: On January 31, Printing Plus took an inventory of its supplies and discovered that \$100 of supplies had been used during the month.

2 U.S. Securities and Exchange Commission. "SEC Charges Mexico-Based Homebuilder in \$3.3 Billion Accounting Fraud. Press Release." March 3, 2017. <https://www.sec.gov/news/pressrelease/2017-60.html>

Analysis:

- \$100 of supplies were used during January. Supplies is an asset that is decreasing (credit).
- Supplies is a type of prepaid expense that, when used, becomes an expense. Supplies Expense would increase (debit) for the \$100 of supplies used during January.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Supplies Expense Supplies <i>To recognize supply usage for January</i>	100	100

Impact on the financial statements: Supplies is a balance sheet account, and Supplies Expense is an income statement account. This satisfies the rule that each adjusting entry will contain an income statement and balance sheet account. We see total assets decrease by \$100 on the balance sheet. Supplies Expense increases overall expenses on the income statement, which reduces net income.

Assets	=	Liabilities	+	Stockholders' Equity
-\$100	=	+\$0	+	-\$100
-\$100	=	\$0	+	-\$100

Transaction 14: The equipment purchased on January 5 depreciated \$75 during the month of January.

Analysis:

- Equipment lost value in the amount of \$75 during January. This depreciation will impact the Accumulated Depreciation–Equipment account and the Depreciation Expense–Equipment account. While we are not doing depreciation calculations here, you will come across more complex calculations in the future.
- Accumulated Depreciation–Equipment is a contra asset account (contrary to Equipment) and increases (credit) for \$75.
- Depreciation Expense–Equipment is an expense account that is increasing (debit) for \$75.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Depreciation Expense: Equipment Accumulated Depreciation: Equipment <i>To recognize equipment depreciation for January</i>	75	75

Impact on the financial statements: Accumulated Depreciation–Equipment is a contra account to Equipment. When calculating the book value of Equipment, Accumulated Depreciation–Equipment will be deducted from the original cost of the equipment. Therefore, total assets will decrease by \$75 on the balance sheet. Depreciation Expense will increase overall expenses on the income statement, which reduces net income.

Assets	=	Liabilities	+	Stockholders' Equity
-\$75	=	+\$0	+	-\$75
-\$75	=	\$0	+	-\$75

Transaction 15: Printing Plus performed \$600 of services during January for the customer from the January 9 transaction.

Analysis:

- The customer from the January 9 transaction gave the company \$4,000 in advanced payment for services. By the end of January the company had earned \$600 of the advanced payment. This means that the company still has yet to provide \$3,400 in services to that customer.
- Since some of the unearned revenue is now earned, Unearned Revenue would decrease. Unearned Revenue is a liability account and decreases on the debit side.
- The company can now recognize the \$600 as earned revenue. Service Revenue increases (credit) for \$600.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Unearned Revenue Service Revenue <i>To recognize revenue earned from January 9 transaction</i>	600	600

Impact on the financial statements: Unearned revenue is a liability account and will decrease total liabilities and equity by \$600 on the balance sheet. Service Revenue will increase overall revenue on the income statement, which increases net income.

Assets	=	Liabilities	+	Stockholders' Equity
\$0	=	-\$600	+	+\$600
\$0	=	-\$600	+	\$600

Transaction 16: Reviewing the company bank statement, Printing Plus discovers \$140 of interest earned during the month of January that was previously uncollected and unrecorded.

Analysis:

- Interest is revenue for the company on money kept in a savings account at the bank. The company only sees the bank statement at the end of the month and needs to record interest revenue that has not yet been collected or recorded.
- Interest Revenue is a revenue account that increases (credit) for \$140.
- Since Printing Plus has yet to collect this interest revenue, it is considered a receivable. Interest Receivable increases (debit) for \$140.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Interest Receivable Interest Revenue <i>To recognize interest revenue earned but not yet collected</i>	140	140

Impact on the financial statements: Interest Receivable is an asset account and will increase total assets by \$140 on the balance sheet. Interest Revenue will increase overall revenue on the income statement, which increases net income.

Assets	=	Liabilities	+	Stockholder's Equity
+\$140	=	\$0	+	+\$140
+\$140	=	\$0	+	+\$140

Transaction 17: Employees earned \$1,500 in salaries for the period of January 21–January 31 that had been previously unpaid and unrecorded.

Analysis:

- Salaries have accumulated since January 21 and will not be paid in the current period. Since the salaries expense occurred in January, the expense recognition principle requires recognition in January.
- Salaries Expense is an expense account that is increasing (debit) for \$1,500.
- Since the company has not yet paid salaries for this time period, Printing Plus owes the employees this money. This creates a liability for Printing Plus. Salaries Payable increases (credit) for \$1,500.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Salaries Expense Salaries Payable <i>To recognize salaries expense but not yet paid</i>	1,500	1,500

Impact on the financial statements: Salaries Payable is a liability account and will increase total liabilities and equity by \$1,500 on the balance sheet. Salaries expense will increase overall expenses on the income statement, which decreases net income.

Assets	=	Liabilities	+	Stockholder's Equity
\$0	=	+\$1,500	+	–\$1,500
\$0	=	+\$1,500	+	–\$1,500

We now explore how these adjusting entries impact the general ledger (T-accounts).

YOUR TURN

Deferrals versus Accruals

Label each of the following as a deferral or an accrual, and explain your answer.

1. The company recorded supplies usage for the month.
2. A customer paid in advance for services, and the company recorded revenue earned after providing service to that customer.
3. The company recorded salaries that had been earned by employees but were previously unrecorded and have not yet been paid.

Solution

1. The company is recording a deferred expense. The company was deferring the recognition of supplies from supplies expense until it had used the supplies.

2. The company has deferred revenue. It deferred the recognition of the revenue until it was actually earned. The customer already paid the cash and is currently on the balance sheet as a liability.
3. The company has an accrued expense. The company is bringing the salaries that have been incurred, added up since the last paycheck, onto the books for the first time during the adjusting entry. Cash will be given to the employees at a later time.

LINK TO LEARNING

Several internet sites can provide additional information for you on adjusting entries. One very good site where you can find many tools to help you study this topic is [Accounting Coach \(https://openstax.org/l/50AcctCoach\)](https://openstax.org/l/50AcctCoach) which provides a tool that is available to you free of charge. Visit the website and take a [quiz on accounting basics \(https://openstax.org/l/50AcctQuiz\)](https://openstax.org/l/50AcctQuiz) to test your knowledge.

Posting Adjusting Entries

Once you have journalized all of your adjusting entries, the next step is posting the entries to your ledger. Posting adjusting entries is no different than posting the regular daily journal entries. T-accounts will be the visual representation for the Printing Plus general ledger.

Transaction 13: On January 31, Printing Plus took an inventory of its supplies and discovered that \$100 of supplies had been used during the month.

Journal entry and T-accounts:

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Supplies Expense Supplies <i>To recognize supply usage for January</i>	100	100

Supplies			
Jan. 30	500	100	Jan. 31
	Bal. 400		

Supplies Expense	
Jan. 31	100
	Bal. 100

In the journal entry, Supplies Expense has a debit of \$100. This is posted to the Supplies Expense T-account on the debit side (left side). Supplies has a credit balance of \$100. This is posted to the Supplies T-account on the credit side (right side). You will notice there is already a debit balance in this account from the purchase of supplies on January 30. The \$100 is deducted from \$500 to get a final debit balance of \$400.

Transaction 14: The equipment purchased on January 5 depreciated \$75 during the month of January.

Journal entry and T-accounts:

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Depreciation Expense: Equipment Accumulated Depreciation: Equipment <i>To recognize equipment depreciation for January</i>	75	75

Depreciation Expense: Equipment	
Jan. 31	75
	Bal. 75

Accumulated Depreciation: Equipment	
75	Jan. 31
Bal. 75	

In the journal entry, Depreciation Expense–Equipment has a debit of \$75. This is posted to the Depreciation Expense–Equipment T-account on the debit side (left side). Accumulated Depreciation–Equipment has a credit balance of \$75. This is posted to the Accumulated Depreciation–Equipment T-account on the credit side (right side).

Transaction 15: Printing Plus performed \$600 of services during January for the customer from the January 9 transaction.

Journal entry and T-accounts:

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Unearned Revenue Service Revenue <i>To recognize revenue earned from January 9 transaction</i>	600	600

Unearned Revenue	
Jan. 31	600
	4,000 Jan. 9
	Bal. 3,400

Service Revenue	
5,500	Jan. 10
2,800	Jan. 17
1,200	Jan. 27
600	Jan. 31
Bal. 10,100	

In the journal entry, Unearned Revenue has a debit of \$600. This is posted to the Unearned Revenue T-account on the debit side (left side). You will notice there is already a credit balance in this account from the January 9 customer payment. The \$600 debit is subtracted from the \$4,000 credit to get a final balance of \$3,400 (credit). Service Revenue has a credit balance of \$600. This is posted to the Service Revenue T-account on the credit side (right side). You will notice there is already a credit balance in this account from other revenue transactions in January. The \$600 is added to the previous \$9,500 balance in the account to get a new final credit balance of \$10,100.

Transaction 16: Reviewing the company bank statement, Printing Plus discovers \$140 of interest earned during the month of January that was previously uncollected and unrecorded.

Journal entry and T-accounts:

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Interest Receivable Interest Revenue <i>To recognize interest revenue earned but not yet collected</i>	140	140

Interest Receivable	
Jan. 31	140
Bal. 140	

Interest Revenue	
140	Jan. 31
Bal. 140	

In the journal entry, Interest Receivable has a debit of \$140. This is posted to the Interest Receivable T-account on the debit side (left side). Interest Revenue has a credit balance of \$140. This is posted to the Interest Revenue T-account on the credit side (right side).

Transaction 17: Employees earned \$1,500 in salaries for the period of January 21–January 31 that had been previously unpaid and unrecorded.

Journal entry and T-accounts:

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Interest Receivable Interest Revenue <i>To recognize interest revenue earned but not yet collected</i>	140	140

Interest Receivable	
Jan. 31	140
Bal. 140	

Interest Revenue	
140	Jan. 31
Bal. 140	

In the journal entry, Salaries Expense has a debit of \$1,500. This is posted to the Salaries Expense T-account on the debit side (left side). You will notice there is already a debit balance in this account from the January 20 employee salary expense. The \$1,500 debit is added to the \$3,600 debit to get a final balance of \$5,100 (debit). Salaries Payable has a credit balance of \$1,500. This is posted to the Salaries Payable T-account on the credit side (right side).

T-accounts Summary

Once all adjusting journal entries have been posted to T-accounts, we can check to make sure the accounting equation remains balanced. Following is a summary showing the T-accounts for Printing Plus including adjusting entries.

Assets				=	Liabilities				+	Equity			
Cash					Accounts Payable					Common Stock			
Jan. 3	20,000	300	Jan. 12		Jan. 18	3,500	3,500	Jan. 5			20,000	Jan. 3	
Jan. 9	4,000	100	Jan. 14				500	Jan. 30					
Jan. 17	2,800	3,500	Jan. 18										
Jan. 23	5,500	3,600	Jan. 20										
	Bal. 24,800						Bal. 500					Bal. 20,000	
Accounts Receivable					Salaries Payable					Dividends			
Jan. 10	5,500	5,500	Jan. 23				1,500	Jan. 31		Jan. 14	100		
Jan. 27	1,200										Bal. 100		
	Bal. 1,200						Bal. 1,500						
Interest Receivable					Unearned Revenue					Service Revenue			
Jan. 31	140				Jan. 31	600	4,000	Jan. 9			5,500	Jan. 10	
	Bal. 140						Bal. 3,400				2,800	Jan. 17	
Supplies											1,200	Jan. 27	
Jan. 30	500	100	Jan. 31								600	Jan. 31	
	Bal. 400											Bal. 10,100	
Equipment										Interest Revenue			
Jan. 5	3,500										140	Jan. 31	
	Bal. 3,500											Bal. 140	
Accumulated Depreciation: Equipment										Supplies Expense			
		75	Jan. 31							Jan. 31	100		
		Bal. 75									Bal. 100		
										Salaries Expense			
										Jan. 20	3,600		
										Jan. 31	1,500		
											Bal. 5,100		
										Utility Expense			
										Jan. 12	300		
											Bal. 300		
										Depreciation Expense: Equipment			
										Jan. 31	75		

Figure 4.5 Printing Plus summary of T-accounts with Adjusting Entries. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The sum on the assets side of the accounting equation equals \$29,965, found by adding together the final balances in each asset account (24,800 + 1,200 + 140 + 400 + 3,500 – 75). To find the total on the liabilities and equity side of the equation, we need to find the difference between debits and credits. Credits on the liabilities and equity side of the equation total \$35,640 (500 + 1,500 + 3,400 + 20,000 + 10,100 + 140). Debits on the liabilities and equity side of the equation total \$5,675 (100 + 100 + 5,100 + 300 + 75). The difference between \$35,640 – \$5,675 = \$29,965. Thus, the equation remains balanced with \$29,965 on the asset side and \$29,965 on the liabilities and equity side. Now that we have the T-account information, and have confirmed the accounting

equation remains balanced, we can create the adjusted trial balance in our sixth step in the accounting cycle.

LINK TO LEARNING

When posting any kind of journal entry to a general ledger, it is important to have an organized system for recording to avoid any account discrepancies and misreporting. To do this, companies can streamline their general ledger and remove any unnecessary processes or accounts. Check out this [article “Encourage General Ledger Efficiency” from the Journal of Accountancy \(https://openstax.org/l/50JrnAcctArticl\)](https://openstax.org/l/50JrnAcctArticl) that discusses some strategies to improve general ledger efficiency.

4.4 Use the Ledger Balances to Prepare an Adjusted Trial Balance

Once all of the adjusting entries have been posted to the general ledger, we are ready to start working on preparing the adjusted trial balance. Preparing an adjusted trial balance is the sixth step in the accounting cycle. An **adjusted trial balance** is a list of all accounts in the general ledger, including adjusting entries, which have nonzero balances. This trial balance is an important step in the accounting process because it helps identify any computational errors throughout the first five steps in the cycle.

As with the unadjusted trial balance, transferring information from T-accounts to the adjusted trial balance requires consideration of the final balance in each account. If the final balance in the ledger account (T-account) is a debit balance, you will record the total in the left column of the trial balance. If the final balance in the ledger account (T-account) is a credit balance, you will record the total in the right column.

Once all ledger accounts and their balances are recorded, the debit and credit columns on the adjusted trial balance are totaled to see if the figures in each column match. The final total in the debit column must be the same dollar amount that is determined in the final credit column.

Let's now take a look at the adjusted T-accounts and adjusted trial balance for Printing Plus to see how the information is transferred from these T-accounts to the adjusted trial balance. We only focus on those general ledger accounts that had balance adjustments.

PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		10,100
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

Interest Receivable		
Jan. 31	140	
Bal. 140		

Supplies			
Jan. 30	500	100	Jan. 31
Bal. 400			

Accumulated Depreciation: Equipment		
	75	Jan. 31
Bal. 75		

Salaries Payable		
	1,500	Jan. 31
Bal. 1,500		

Unearned Revenue		
Jan. 31	600	Jan. 9
Bal. 3,400		

Service Revenue		
	5,500	Jan. 10
	2,800	Jan. 17
	1,200	Jan. 27
	600	Jan. 31
Bal. 10,100		

Interest Revenue		
	140	Jan. 31
Bal. 140		

Supplies Expense		
Jan. 31	100	
Bal. 100		

Salaries Expense		
Jan. 20	3,600	
Jan. 31	1,500	
Bal. 5,100		

Depreciation Expense: Equipment		
Jan. 31	75	
Bal. 75		

For example, Interest Receivable is an adjusted account that has a final balance of \$140 on the debit side. This balance is transferred to the Interest Receivable account in the debit column on the adjusted trial balance. Supplies (\$400), Supplies Expense (\$100), Salaries Expense (\$5,100), and Depreciation Expense—Equipment (\$75) also have debit final balances in their adjusted T-accounts, so this information will be transferred to the debit column on the adjusted trial balance. Accumulated Depreciation—Equipment (\$75), Salaries Payable (\$1,500), Unearned Revenue (\$3,400), Service Revenue (\$10,100), and Interest Revenue (\$140) all have credit final balances in their T-accounts. These credit balances would transfer to the credit column on the adjusted trial balance.

Once all balances are transferred to the adjusted trial balance, we sum each of the debit and credit columns. The debit and credit columns both total \$35,715, which means they are equal and in balance.

PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		<u>10,100</u>
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

After the adjusted trial balance is complete, we next prepare the company's financial statements.

THINK IT THROUGH

Cash or Accrual Basis Accounting?

You are a new accountant at a salon. The salon had previously used cash basis accounting to prepare its financial records but now considers switching to an accrual basis method. You have been tasked with determining if this transition is appropriate.

When you go through the records you notice that this transition will greatly impact how the salon reports revenues and expenses. The salon will now report some revenues and expenses before it receives or pays cash.

How will change positively impact its business reporting? How will it negatively impact its business reporting? If you were the accountant, would you recommend the salon transition from cash basis to accrual basis?

CONCEPTS IN PRACTICE

Why Is the Adjusted Trial Balance So Important?

As you have learned, the adjusted trial balance is an important step in the accounting process. But outside of the accounting department, why is the adjusted trial balance important to the rest of the

organization? An employee or customer may not immediately see the impact of the adjusted trial balance on his or her involvement with the company.

The adjusted trial balance is the key point to ensure all debits and credits are in the general ledger accounts balance before information is transferred to financial statements. Financial statements drive decision-making for a business. Budgeting for employee salaries, revenue expectations, sales prices, expense reductions, and long-term growth strategies are all impacted by what is provided on the financial statements.

So if the company skips over creating an adjusted trial balance to make sure all accounts are balanced or adjusted, it runs the risk of creating incorrect financial statements and making important decisions based on inaccurate financial information.

4.5

Prepare Financial Statements Using the Adjusted Trial Balance

Once you have prepared the adjusted trial balance, you are ready to prepare the financial statements. Preparing financial statements is the seventh step in the accounting cycle. Remember that we have four financial statements to prepare: an income statement, a statement of retained earnings, a balance sheet, and the statement of cash flows. These financial statements were introduced in [Introduction to Financial Statements](#) and [Statement of Cash Flows](#) dedicates in-depth discussion to that statement.

To prepare the financial statements, a company will look at the adjusted trial balance for account information. From this information, the company will begin constructing each of the statements, beginning with the income statement. Income statements will include all revenue and expense accounts. The statement of retained earnings will include beginning retained earnings, any net income (loss) (found on the income statement), and dividends. The balance sheet is going to include assets, contra assets, liabilities, and stockholder equity accounts, including ending retained earnings and common stock.

YOUR TURN

Magnificent Adjusted Trial Balance

MAGNIFICENT LANDSCAPING SERVICE Adjusted Trial Balance April 30, 2018		
Account Title	Debit	Credit
Cash	\$2,950	
Accounts Receivable	575	
Office Supplies	40	
Prepaid Insurance	240	
Equipment	2,500	
Accumulated Depreciation: Equipment		\$ 35
Accounts Payable		28
Salaries Payable		420
Unearned Lawn Mowing Revenue		100
Common Stock		5,000
Dividends	1,000	
Lawn Mowing Revenue		2,350
Gas Expense	53	
Advertising Expense	35	
Depreciation Expense: Equipment	35	
Supplies Expense	85	
Salaries Expense	420	
	<u>\$7,933</u>	<u>\$7,933</u>

Go over the adjusted trial balance for Magnificent Landscaping Service. Identify which income statement each account will go on: Balance Sheet, Statement of Retained Earnings, or Income Statement.

Solution

Balance Sheet: Cash, accounts receivable, office supplied, prepaid insurance, equipment, accumulated depreciation (equipment), accounts payable, salaries payable, unearned lawn mowing revenue, and common stock. Statement of Retained Earnings: Dividends. Income Statement: Lawn mowing revenue, gas expense, advertising expense, depreciation expense (equipment), supplies expense, and salaries expense.

Income Statement

An income statement shows the organization's financial performance for a given period of time. When preparing an income statement, revenues will always come before expenses in the presentation. For Printing Plus, the following is its January 2019 Income Statement.

PRINTING PLUS Income Statement For the Month Ended January 31, 2019		
Revenues		
Interest Revenue	\$ 140	
Service Revenue	<u>10,100</u>	
Total Revenues		\$10,240
Expenses		
Supplies Expense	100	
Depreciation Expense		
Equipment	75	
Salaries Expense	5,100	
Utility Expense	<u>300</u>	
Total Expenses		<u>5,575</u>
Net Income		<u>\$ 4,665</u>

Revenue and expense information is taken from the adjusted trial balance as follows:

PRINTING PLUS Income Statement For the Month Ended January 31, 2019		
Revenues		
Interest Revenue	\$ 140	
Service Revenue	<u>10,100</u>	
Total Revenues		\$10,240
Expenses		
Supplies Expense	100	
Depreciation Expense:		
Equipment	75	
Salaries Expense	5,100	
Utility Expense	<u>300</u>	
Total Expenses		<u>5,575</u>
Net Income		<u>\$ 4,665</u>

PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Acc. Dep: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		10,100
Supplies Expense	100	
Depreciation Expense:		
Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

Total revenues are \$10,240, while total expenses are \$5,575. Total expenses are subtracted from total revenues

to get a net income of \$4,665. If total expenses were more than total revenues, Printing Plus would have a net loss rather than a net income. This net income figure is used to prepare the statement of retained earnings.

CONCEPTS IN PRACTICE

The Importance of Accurate Financial Statements

Financial statements give a glimpse into the operations of a company, and investors, lenders, owners, and others rely on the accuracy of this information when making future investing, lending, and growth decisions. When one of these statements is inaccurate, the financial implications are great.

For example, **Celadon Group** misreported revenues over the span of three years and elevated earnings during those years. The total overreported income was approximately \$200–\$250 million. This gross misreporting misled investors and led to the removal of **Celadon Group** from the New York Stock Exchange. Not only did this negatively impact **Celadon Group**'s stock price and lead to criminal investigations, but investors and lenders were left to wonder what might happen to their investment.

That is why it is so important to go through the detailed accounting process to reduce errors early on and hopefully prevent misinformation from reaching financial statements. The business must have strong internal controls and best practices to ensure the information is presented fairly.^[3]

Statement of Retained Earnings

The statement of retained earnings (which is often a component of the statement of stockholders' equity) shows how the equity (or value) of the organization has changed over a period of time. The statement of retained earnings is prepared second to determine the ending retained earnings balance for the period. The statement of retained earnings is prepared before the balance sheet because the ending retained earnings amount is a required element of the balance sheet. The following is the Statement of Retained Earnings for Printing Plus.

PRINTING PLUS Statement of Retained Earnings For Month Ended January 31, 2019	
Beginning Retained Earnings (Jan 1)	\$
Net Income	<u>4,665</u>
	4,665
– Dividends	100
Ending Retained Earnings (Jan 31)	<u><u>\$4,565</u></u>

Net income information is taken from the income statement, and dividends information is taken from the adjusted trial balance as follows.

3 James Jaillet. "Celadon under Criminal Investigation over Financial Statements." *Commercial Carrier Journal*. July 25, 2018. <https://www.ccdigital.com/200520-2/>

PRINTING PLUS Statement of Retained Earnings For Month Ended January 31, 2019	
Beginning Retained Earnings (Jan 1)	\$
Net Income	<u>4,665</u>
	4,665
– Dividends	<u>100</u>
Ending Retained Earnings (Jan 31)	<u><u>\$4,565</u></u>

PRINTING PLUS Income Statement For Month Ended January 31, 2019		
Revenues		
Interest Revenue	\$ 140	
Service Revenue	<u>10,100</u>	
Total Revenues		\$10,240
Expenses		
Supplies Expense	100	
Depreciation Expense		
Equipment	75	
Salaries Expense	5,100	
Utility Expense	<u>300</u>	
Total Expenses		<u>5,575</u>
Net Income		<u><u>\$ 4,665</u></u>

PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation		
Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		<u>10,100</u>
Supplies Expense	100	
Depreciation Expense		
Equipment	75	
Salaries Expense	5,100	
Utility Expense	<u>300</u>	
Total	<u><u>\$35,715</u></u>	<u><u>\$35,715</u></u>

The statement of retained earnings always leads with beginning retained earnings. Beginning retained earnings carry over from the previous period's ending retained earnings balance. Since this is the first month of business for Printing Plus, there is no beginning retained earnings balance. Notice the net income of \$4,665 from the income statement is carried over to the statement of retained earnings. Dividends are taken away from the sum of beginning retained earnings and net income to get the ending retained earnings balance of

\$4,565 for January. This ending retained earnings balance is transferred to the balance sheet.

LINK TO LEARNING

Concepts Statements give the Financial Accounting Standards Board (FASB) a guide to creating accounting principles and consider the limitations of financial statement reporting. See the [FASB's "Concepts Statements" page \(https://openstax.org/l/50FASBConState\)](https://openstax.org/l/50FASBConState) to learn more.

Balance Sheet

The balance sheet is the third statement prepared after the statement of retained earnings and lists what the organization owns (*assets*), what it owes (*liabilities*), and what the shareholders control (*equity*) on a specific date. Remember that the balance sheet represents the accounting equation, where assets equal liabilities plus stockholders' equity. The following is the Balance Sheet for Printing Plus.

PRINTING PLUS Balance Sheet January 31, 2019		
Assets		
Cash		\$24,800
Accounts Receivable		1,200
Interest Receivable		140
Supplies		400
Equipment	\$3,500	
Accumulated Depreciation: Equipment	(75)	3,425
Total Assets		\$29,965
Liabilities		
Accounts Payable		\$ 500
Salaries Payable		1,500
Unearned Revenue		3,400
Total Liabilities		5,400
Stockholders' Equity		
Common Stock		20,000
Ending Retained Earnings		4,565
Total Stockholders' Equity		24,565
Total Liabilities and Stockholders' Equity		\$29,965

Ending retained earnings information is taken from the statement of retained earnings, and asset, liability, and common stock information is taken from the adjusted trial balance as follows.

PRINTING PLUS Balance Sheet January 31, 2019		PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Assets		Account	Debit	Credit
Cash	\$24,800	Cash	\$24,800	
Accounts Receivable	1,200	Accounts Receivable	1,200	
Interest Receivable	140	Interest Receivable	140	
Supplies	400	Supplies	400	
Equipment	\$3,500	Equipment	3,500	
Accumulated Depreciation Equipment	75	Acc. Dep: Equip.		\$ 75
Total Assets	<u>\$29,965</u>	Accounts Payable		500
Liabilities		Salaries Payable		1,500
Accounts Payable	\$ 500	Unearned Revenue		3,400
Salaries Payable	1,500	Common Stock		20,000
Unearned Revenue	3,400	Dividends	100	
Total Liabilities	<u>5,400</u>	Interest Revenue		140
Stockholders' Equity		Service Revenue		10,100
Common Stock	20,000	Supplies Expense	100	
Ending Retained Earnings	4,565	Dep. Expense: Equip.	75	
Total Stockholders' Equity	<u>24,565</u>	Salaries Expense	5,100	
Total Liabilities and Stockholders' Equity	<u>\$29,965</u>	Utility Expense	300	
		Total	<u>\$35,715</u>	<u>\$35,715</u>

PRINTING PLUS Statement of Retained Earnings For the Month Ended January 31, 2019	
Beginning Retained Earnings (Jan. 1)	\$ 0
Net Income	4,665
Dividends	(100)
Ending Retained Earnings (Jan. 31)	<u>\$4,565</u>

Looking at the asset section of the balance sheet, Accumulated Depreciation–Equipment is included as a contra asset account to equipment. The accumulated depreciation (\$75) is taken away from the original cost of the equipment (\$3,500) to show the book value of equipment (\$3,425). The accounting equation is balanced, as shown on the balance sheet, because total assets equal \$29,965 as do the total liabilities and stockholders' equity.

There is a worksheet approach a company may use to make sure end-of-period adjustments translate to the correct financial statements.

IFRS CONNECTION

Financial Statements

Both US-based companies and those headquartered in other countries produce the same primary financial statements—Income Statement, Balance Sheet, and Statement of Cash Flows. The presentation

of these three primary financial statements is largely similar with respect to what should be reported under US GAAP and IFRS, but some interesting differences can arise, especially when presenting the Balance Sheet.

While both US GAAP and IFRS require the same minimum elements that must be reported on the Income Statement, such as revenues, expenses, taxes, and net income, to name a few, publicly traded companies in the United States have further requirements placed by the SEC on the reporting of financial statements. For example, IFRS-based financial statements are only required to report the current period of information and the information for the prior period. US GAAP has no requirement for reporting prior periods, but the SEC requires that companies present one prior period for the Balance Sheet and three prior periods for the Income Statement. Under both IFRS and US GAAP, companies can report more than the minimum requirements.

Presentation differences are most noticeable between the two forms of GAAP in the Balance Sheet. Under US GAAP there is no specific requirement on how accounts should be presented. However, the SEC requires that companies present their Balance Sheet information in liquidity order, which means current assets listed first with cash being the first account presented, as it is a company's most liquid account. Liquidity refers to how easily an item can be converted to cash. IFRS requires that accounts be classified into current and noncurrent categories for both assets and liabilities, but no specific presentation format is required. Thus, for US companies, the first category always seen on a Balance Sheet is Current Assets, and the first account balance reported is cash. This is not always the case under IFRS. While many Balance Sheets of international companies will be presented in the same manner as those of a US company, the lack of a required format means that a company can present noncurrent assets first, followed by current assets. The accounts of a Balance Sheet using IFRS might appear as shown here.

INTERNATIONAL COMPANY		
Balance Sheet		
December 31, 2020		
Assets		
Noncurrent Assets		
Buildings	\$1,500,000	
Equipment	<u>800,000</u>	
Total Noncurrent Assets		\$2,300,000
Current Assets		
Investments	\$ 100,000	
Inventory	500,000	
Accounts Receivable	400,000	
Cash	<u>200,000</u>	
Total Current Assets		<u>1,200,000</u>
Total Assets		<u><u>\$3,500,000</u></u>
Share Equity and Liabilities		
Share Equity		
Share Capital	\$ 550,000	
Retained Earnings	<u>750,000</u>	
Total Share Equity		\$1,300,000
Long-term Liabilities		
Pensions	\$ 875,000	
Note Payable	<u>\$ 225,000</u>	
Total Long-term Liabilities		1,200,000
Current Liabilities		
Short-term Note Payable	\$ 650,000	
Accounts Payable	<u>\$ 350,000</u>	
Total Current Liabilities		<u>1,000,000</u>
Total Share Equity and Liabilities		<u><u>\$3,500,000</u></u>

Review [the annual report of Stora Enso \(https://openstax.org/l/50StoraEnso2017\)](https://openstax.org/l/50StoraEnso2017) which is an international company that utilizes the illustrated format in presenting its Balance Sheet, also called the Statement of Financial Position. The Balance Sheet is found on page 31 of the report.

Some of the biggest differences that occur on financial statements prepared under US GAAP versus IFRS relate primarily to measurement or timing issues: in other words, how a transaction is valued and when it is recorded.

Ten-Column Worksheets

The **10-column worksheet** is an all-in-one spreadsheet showing the transition of account information from the trial balance through the financial statements. Accountants use the 10-column worksheet to help calculate end-of-period adjustments. Using a 10-column worksheet is an optional step companies may use in their accounting process.

Here is a picture of a 10-column worksheet for Printing Plus.

PRINTING PLUS										
10-Column Worksheet										
For the Month Ended January, 2019										
Account Name	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	24,800				24,800				24,800	
Accounts Receivable	1,200				1,200				1,200	
Interest Receivable			140		140				140	
Supplies	500			100	400				400	
Equipment	3,500				3,500				3,500	
Accumulated Depreciation: Equipment				75		75				75
Accounts Payable		500				500				500
Salaries Payable				1,500		1,500				1,500
Unearned Revenue		4,000	600			3,400				3,400
Common Stock		20,000				20,000				20,000
Dividends	100				100				100	
Interest Revenue				140		140		140		
Service Revenue		9,500		600		10,100		10,100		
Supplies Expense			100		100		100			
Depreciation Expense: Equipment			75		75		75			
Salaries Expense	3,600		1,500		5,100		5,100			
Utility Expense	300				300		300			
Totals	34,000	34,000	2,415	2,415	35,715	35,715	5,575	10,240	30,140	25,475
Net Income							4,665			4,665
							10,240	10,240	30,140	30,140

There are five sets of columns, each set having a column for debit and credit, for a total of 10 columns. The five column sets are the trial balance, adjustments, adjusted trial balance, income statement, and the balance sheet. After a company posts its day-to-day journal entries, it can begin transferring that information to the trial balance columns of the 10-column worksheet.

PRINTING PLUS		
10-Column Worksheet		
For the Month Ended January, 2019		
Account Name	Trial Balance	
	Debit	Credit
Cash	24,800	
Accounts Receivable	1,200	
Interest Receivable		
Supplies	500	
Equipment	3,500	
Accumulated Depreciation: Equipment		
Accounts Payable		500
Salaries Payable		
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Interest Revenue		
Service Revenue		<u>9,500</u>
Supplies Expense		
Depreciation Expense: Equipment		
Salaries Expense	3,600	
Utility Expense	<u>300</u>	
Totals	<u>34,000</u>	<u>34,000</u>
Net Income		

The trial balance information for Printing Plus is shown previously. Notice that the debit and credit columns both equal \$34,000. If we go back and look at the trial balance for Printing Plus, we see that the trial balance shows debits and credits equal to \$34,000.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		9,500
Salaries Expense	3,600	
Utility Expense	300	
Total	<u>\$34,000</u>	<u>\$34,000</u>

Once the trial balance information is on the worksheet, the next step is to fill in the adjusting information from the posted adjusted journal entries.

PRINTING PLUS				
10-Column Worksheet				
For the Month Ended January, 2019				
Account Name	Trial Balance		Adjustments	
	Debit	Credit	Debit	Credit
Cash	24,800			
Accounts Receivable	1,200			
Interest Receivable			140	
Supplies	500			100
Equipment	3,500			
Accumulated Depreciation: Equipment				75
Accounts Payable		500		
Salaries Payable				1,500
Unearned Revenue		4,000	600	
Common Stock		20,000		
Dividends	100			
Interest Revenue				140
Service Revenue		<u>9,500</u>		<u>600</u>
Supplies Expense			100	
Depreciation Expense: Equipment			75	
Salaries Expense	3,600		<u>1,500</u>	
Utility Expense	<u>300</u>			
Totals	<u>34,000</u>	<u>34,000</u>	<u>2,415</u>	<u>2,415</u>
Net Income				

The adjustments total of \$2,415 balances in the debit and credit columns.

The next step is to record information in the adjusted trial balance columns.

PRINTING PLUS						
10-Column Worksheet						
For the Month Ended January, 2019						
Account Name	Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	24,800				24,800	
Accounts Receivable	1,200				1,200	
Interest Receivable			140		140	
Supplies	500			100	400	
Equipment	3,500				3,500	
Accumulated Depreciation: Equipment				75		75
Accounts Payable		500				500
Salaries Payable				1,500		1,500
Unearned Revenue		4,000	600			3,400
Common Stock		20,000				20,000
Dividends	100				100	
Interest Revenue				140		140
Service Revenue		9,500		600		10,100
Supplies Expense			100		100	
Depreciation Expense: Equipment			75		75	
Salaries Expense	3,600		1,500		5,100	
Utility Expense	300				300	
Totals	34,000	34,000	2,415	2,415	35,715	35,715
Net Income						

To get the numbers in these columns, you take the number in the trial balance column and add or subtract any number found in the adjustment column. For example, Cash shows an unadjusted balance of \$24,800. There is no adjustment in the adjustment columns, so the Cash balance from the unadjusted balance column is transferred over to the adjusted trial balance columns at \$24,800. Interest Receivable did not exist in the trial balance information, so the balance in the adjustment column of \$140 is transferred over to the adjusted trial balance column.

Unearned revenue had a credit balance of \$4,000 in the trial balance column, and a debit adjustment of \$600 in the adjustment column. Remember that adding debits and credits is like adding positive and negative numbers. This means the \$600 debit is subtracted from the \$4,000 credit to get a credit balance of \$3,400 that is translated to the adjusted trial balance column.

Service Revenue had a \$9,500 credit balance in the trial balance column, and a \$600 credit balance in the Adjustments column. To get the \$10,100 credit balance in the adjusted trial balance column requires adding together both credits in the trial balance and adjustment columns ($9,500 + 600$). You will do the same process for all accounts. Once all accounts have balances in the adjusted trial balance columns, add the debits and

credits to make sure they are equal. In the case of Printing Plus, the balances equal \$35,715. If you check the adjusted trial balance for Printing Plus, you will see the same equal balance is present.

PRINTING PLUS Adjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		10,100
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

Next you will take all of the figures in the adjusted trial balance columns and carry them over to *either* the income statement columns or the balance sheet columns.

YOUR TURN

Income Statement and Balance Sheet

MAGNIFICENT LANDSCAPING SERVICE										
Worksheet										
April 30, 2018										
Account Name	Trial Balance		Adjustments		Adjusted Trial		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	2,950				2,950					
Accounts Receivable	575				575					
Office Supplies	85			(c) 45	40					
Prepaid Insurance	240				240					
Equipment	2,540			(b) 40	2,500					
Accounts Payable		28				28				
Unearned Lawn Mowing Revenue		200	(d) 100			100				
Common Stock		5,000				5,000				
Dividends	1,000				1,000					
Lawn Mowing Revenue		2,250		(d) 100		2,350				
Gas Expense	53				53					
Advertising Expense	35				35					
	<u>7,478</u>	<u>7,478</u>								
Depreciation Expense: Equipment			(a) 35		35					
Accumulated Depreciating: Equipment				(a) 35		35				
Supplies Expense			(b) 40 (c) 45		85					
Salaries Expense			(e) 420		420					
Salaries Payable				(e) 420		420				
			<u>640</u>	<u>640</u>	<u>7,933</u>	<u>7,933</u>				

Take a couple of minutes and fill in the income statement and balance sheet columns. Total them when you are done. Do not panic when they do not balance. They will not balance at this time.

Solution

MAGNIFICENT LANDSCAPING SERVICE										
Worksheet										
April 30, 2018										
Account Name	Trial Balance		Adjustments		Adjusted Trial		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	2,950				2,950				2,950	
Accounts Receivable	575				575				575	
Office Supplies	85			(c) 45	40				40	
Prepaid Insurance	240				240				240	
Equipment	2,540			(b) 40	2,500				2,500	
Accounts Payable		28				28				28
Unearned Lawn Mowing Revenue		200	(d) 100			100				100
Common Stock		5,000				5,000				5,000
Dividends	1,000				1,000				1,000	
Lawn Mowing Revenue		2,250		(d) 100		2,350		2,350		
Gas Expense	53				53		53			
Advertising Expense	35				35		35			
	<u>7,478</u>	<u>7,478</u>								
Depreciation Expense: Equipment			(a) 35		35		35			
Accumulated Depreciation: Equipment				(a) 35		35				35
Supplies Expense			(b) 40 (c) 45		85		85			
Salaries Expense			(e) 420		420		420			
Salaries Payable				(e) 420		420				420
			<u>640</u>	<u>640</u>	<u>7,933</u>	<u>7,933</u>	628	2,350	7,305	5,583

Every other account title has been highlighted to help your eyes focus better while checking your work.

Looking at the income statement columns, we see that all revenue and expense accounts are listed in either the debit or credit column. This is a reminder that the income statement itself does not organize information into debits and credits, but we do use this presentation on a 10-column worksheet.

PRINTING PLUS								
10-column Worksheet								
For the Month Ended January, 2019								
Account Name	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	24,800				24,800			
Accounts Receivable	1,200				1,200			
Interest Receivable			140		140			
Supplies	500			100	400			
Equipment	3,500				3,500			
Accumulated Depreciation: Equipment				75		75		
Accounts Payable		500				500		
Salaries Payable				1,500		1,500		
Unearned Revenue		4,000	600			3,400		
Common Stock		20,000				20,000		
Dividends	100				100			
Interest Revenue				140		140		140
Service Revenue		9,500		600		10,100		10,100
Supplies Expense			100		100		100	
Depreciation Expense: Equipment			75		75		75	
Salaries Expense	3,600		1,500		5,100		5,100	
Utility Expense	300				300		300	
Totals	<u>34,000</u>	<u>34,000</u>	<u>2,415</u>	<u>2,415</u>	<u>35,715</u>	<u>35,715</u>	5,575	10,240
Net Income							<u>4,665</u>	
							<u>10,240</u>	<u>10,240</u>

You will notice that when debit and credit income statement columns are totaled, the balances are not the same. The debit balance equals \$5,575, and the credit balance equals \$10,240. Why do they not balance?

If the debit and credit columns equal each other, it means the expenses equal the revenues. This would happen if a company broke even, meaning the company did not make or lose any money. If there is a difference between the two numbers, that difference is the amount of net income, or net loss, the company has earned.

In the Printing Plus case, the credit side is the higher figure at \$10,240. The credit side represents revenues. This means revenues exceed expenses, thus giving the company a net income. If the debit column were larger, this would mean the expenses were larger than revenues, leading to a net loss. You want to calculate the net income and enter it onto the worksheet. The \$4,665 net income is found by taking the credit of \$10,240 and subtracting the debit of \$5,575. When entering net income, it should be written in the column with the lower total. In this instance, that would be the debit side. You then add together the \$5,575 and \$4,665 to get a total

of \$10,240. This balances the two columns for the income statement. If you review the income statement, you see that net income is in fact \$4,665.

PRINTING PLUS Income Statement For the Month Ended January 31, 2019		
Revenues		
Interest Revenue	\$ 140	
Service Revenue	<u>10,100</u>	
Total Revenues		\$10,240
Expenses		
Supplies Expense	100	
Depreciation Expense: Equip.	75	
Salaries Expense	5,100	
Utility Expense	<u>300</u>	
Total Expenses		<u>5,575</u>
Net Income		\$ <u>4,665</u>

PRINTING PLUS										
10-Column Worksheet										
For the Month Ended January, 2019										
Account Name	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	24,800				24,800				24,800	
Accounts Receivable	1,200				1,200				1,200	
Interest Receivable			140		140				140	
Supplies	500			100	400				400	
Equipment	3,500				3,500				3,500	
Acc. Dep: Equip.				75		75				75
Accounts Payable		500				500				500
Salaries Payable				1,500		1,500				1,500
Unearned Revenue		4,000	600			3,400				3,400
Common Stock		20,000				20,000				20,000
Dividends	100				100				100	
Interest Revenue				140		140		140		
Service Revenue		9,500		600		10,100		10,100		
Supplies Expense			100		100		100			
Dep. Exp: Equip.			75		75		75			
Salaries Expense	3,600		1,500		5,100		5,100			
Utility Expense	300				300		300			
Totals	34,000	34,000	2,415	2,415	35,715	35,715	5,575	10,240	30,140	25,475
Net Income							4,665			4,665
							10,240	10,240	30,140	30,140

We now consider the last two columns for the balance sheet. In these columns we record all asset, liability, and equity accounts.

When adding the total debits and credits, you notice they do not balance. The debit column equals \$30,140, and the credit column equals \$25,475. How do we get the columns to balance?

Treat the income statement and balance sheet columns like a double-entry accounting system, where if you have a debit on the income statement side, you must have a credit equaling the same amount on the credit side. In this case we added a debit of \$4,665 to the income statement column. This means we must add a credit of \$4,665 to the balance sheet column. Once we add the \$4,665 to the credit side of the balance sheet column, the two columns equal \$30,140.

You may notice that dividends are included in our 10-column worksheet balance sheet columns even though this account is not included on a balance sheet. So why is it included here? There is actually a very good reason

we put dividends in the balance sheet columns.

When you prepare a balance sheet, you must first have the most updated retained earnings balance. To get that balance, you take the beginning retained earnings balance + net income – dividends. If you look at the worksheet for Printing Plus, you will notice there is no retained earnings account. That is because they just started business this month and have no beginning retained earnings balance.

If you look in the balance sheet columns, we do have the new, up-to-date retained earnings, but it is spread out through two numbers. You have the dividends balance of \$100 and net income of \$4,665. If you combine these two individual numbers (\$4,665 – \$100), you will have your updated retained earnings balance of \$4,565, as seen on the statement of retained earnings.

PRINTING PLUS Statement of Retained Earnings For the Month Ended January 31, 2019	
Beginning Retained Earnings (Jan. 1)	\$ 0
Net Income	<u>4,665</u>
Dividends	<u>(100)</u>
Ending Retained Earnings (Jan. 31)	<u>\$4,565</u>

You will not see a similarity between the 10-column worksheet and the balance sheet, because the 10-column worksheet is categorizing all accounts by the type of balance they have, debit or credit. This leads to a final balance of \$30,140.

The balance sheet is classifying the accounts by type of accounts, assets and contra assets, liabilities, and equity. This leads to a final balance of \$29,965. Even though they are the same numbers in the accounts, the totals on the worksheet and the totals on the balance sheet will be different because of the different presentation methods.

LINK TO LEARNING

Publicly traded companies release their financial statements quarterly for open viewing by the general public, which can usually be viewed on their websites. One such company is Alphabet, Inc. (trade name Google). Take a look at [Alphabet's quarter ended March 31, 2018, financial statements](https://openstax.org/l/50AlphaMar2018) (<https://openstax.org/l/50AlphaMar2018>) from the SEC Form 10-Q.

YOUR TURN

Frank's Net Income and Loss

What amount of net income/loss does Frank have?

FRANK INVESTMENT ADVISERS										
Work Sheet										
For the Month Ended December 31, 2016										
Account Name	Trial Balance		Adjustments		Adjusted Trial		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	28,000				28,000				28,000	
Accounts Receivable	46,000				46,000				46,000	
Office Supplies	5,000			(b) 1,000	4,000				4,000	
Equipment	28,000				28,000				28,000	
Accumulated Depreciation-Equipment		14,000		(c) 2,800		16,800				16,800
Accounts Payable		16,000				16,000				16,000
Salaries Payable				(d) 2,000		2,000				2,000
Unearned Revenue		2,000	(a) 100			1,900				1,900
Notes Payable (Long Term)		23,000				23,000				23,000
Common Stock		15,000				15,000				15,000
Retained Earnings		52,000				52,000				52,000
Dividends	20,000				20,000				20,000	
Service Revenue		55,000		(a) 100		55,100		55,100		
Insurance Expense	3,000				3,000		3,000			
Salaries Expense	35,000		(d) 2,000		37,000		37,000			
Supplies Expense			(b) 1,000		1,000		1,000			
Interest Expense	4,000				4,000		4,000			
Rent Expense	8,000				8,000		8,000			
Depreciation Expense-Equipment			(c) 2,800		2,800		2,800			
	<u>177,000</u>	<u>177,000</u>	<u>5,900</u>	<u>5,900</u>	<u>181,800</u>	<u>181,800</u>	55,800	55,100	126,000	126,700

Solution

FRANK INVESTMENT ADVISERS										
Worksheet										
For the Month Ended December 31, 2016										
Account Name	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	24,800				28,000				24,800	
Accounts Receivable	46,000				46,000				46,000	
Office Supplies	5,000			1,000 b	4,000				4,000	
Equipment	28,000				28,000				28,000	
Accumulated Depreciation: Equipment		14,000		2,800 c		16,800				16,800
Accounts Payable		16,000				16,000				16,000
Salaries Payable				2,000 d		2,000				2,000
Unearned Revenue		2,000	a 100			1,900				1,900
Notes Payable (long term)		23,000				23,000				23,000
Common Stock		15,000				15,000				15,000
Retained Earnings		52,000				52,000				52,000
Dividends	20,000				20,000				20,000	
Service Revenue		55,000		100 a		55,100		55,100		
Insurance Expense	3,000				3,000		3,000			
Salaries Expense	35,000		d 2,000		37,000		37,000			
Supplies Expense			b 1,000		1,000		1,000			
Interest Expense	4,000				4,000		4,000			
Rent Expense	8,000				8,000		8,000			
Depreciation Expense: Equipment			c 2,800		2,800		2,800			
	<u>177,000</u>	<u>177,000</u>	<u>5,900</u>	<u>5,900</u>	<u>181,800</u>	<u>181,800</u>	55,800	55,100	126,000	126,700
Net Loss								700		
							<u>55,800</u>	<u>55,800</u>		

In [Completing the Accounting Cycle](#), we continue our discussion of the accounting cycle, completing the last steps of journalizing and posting closing entries and preparing a post-closing trial balance.

Key Terms

10-column worksheet all-in-one spreadsheet showing the transition of account information from the trial balance through the financial statements

accounting period breaks down company financial information into specific time spans and can cover a month, quarter, half-year, or full year

accrual type of adjusting entry that accumulates during a period, where an amount was previously unrecorded

accrued expense expense incurred in a period but not yet recorded, and no money has been paid

accrued revenue revenue earned in a period but not yet recorded, and no money has been collected

adjusted trial balance list of all accounts in the general ledger, including adjusting entries, which have nonzero balances

adjusting entries update accounting records at the end of a period for any transactions that have not yet been recorded

book value difference between the asset's value (cost) and accumulated depreciation; also, value at which assets or liabilities are recorded in a company's financial statements

calendar year reports financial data from January 1 to December 31 of a specific year

contra account account paired with another account type that has an opposite normal balance to the paired account; reduces or increases the balance in the paired account at the end of a period

deferral prepaid expense and revenue accounts that have delayed recognition until they have been used or earned

fiscal year twelve-month reporting cycle that can begin in any month, and records financial data for that twelve-month consecutive period

interim period any reporting period shorter than a full year (fiscal or calendar)

modified accrual accounting commonly used in governmental accounting and combines accrual basis and cash basis accounting

tax basis accounting establishes the tax effects of transactions in determining the tax liability of an organization

useful life time period over which an asset cost is allocated

Summary

4.1 Explain the Concepts and Guidelines Affecting Adjusting Entries

- The next three steps in the accounting cycle are adjusting entries (journalizing and posting), preparing an adjusted trial balance, and preparing the financial statements. These steps consider end-of-period transactions and their impact on financial statements.
- Accrual basis accounting is used by US GAAP or IFRS-governed companies, and it requires revenues and expenses to be recorded in the accounting period in which they occur, not necessarily where an associated cash event happened. This is unlike cash basis accounting that will delay reporting revenues and expenses until a cash event occurs.
- Companies need timely and consistent financial information presented for users to consider in their decision-making. Accounting periods help companies do this by breaking down information into months, quarters, half-years, and full years.
- A calendar year considers financial information for a company for the time period of January 1 to December 31 on a specific year. A fiscal year is any twelve-month reporting cycle not beginning on

January 1 and ending on December 31.

- An interim period is any reporting period that does not cover a full year. This can be useful when needing timely information for users making financial decisions.

4.2 Discuss the Adjustment Process and Illustrate Common Types of Adjusting Entries

- **Incorrect balances:** Incorrect balances on the unadjusted trial balance occur because not every transaction produces an original source document that will alert the bookkeeper it is time to make an entry. It is not that the accountant made an error, it means an adjustment is required to correct the balance.
- **Need for adjustments:** Some account adjustments are needed to update records that may not have original source documents or those that do not reflect change on a daily basis. The revenue recognition principle, expense recognition principle, and time period assumption all further the need for adjusting entries because they require revenue and expense reporting occur when earned and incurred in a current period.
- **Prepaid expenses:** Prepaid expenses are assets paid for before their use. When they are used, this asset's value is reduced and an expense is recognized. Some examples include supplies, insurance, and depreciation.
- **Unearned revenues:** These are customer advanced payments for product or services yet to be provided. When the company provides the product or service, revenue is then recognized.
- **Accrued revenues:** Accrued revenues are revenues earned in a period but have yet to be recorded and no money has been collected. Accrued revenues are updated at the end of the period to recognize revenue and money owed to the company.
- **Accrued expenses:** Accrued expenses are incurred in a period but have yet to be recorded and no money has been paid. Accrued expenses are updated to reflect the expense and the company's liability.

4.3 Record and Post the Common Types of Adjusting Entries

- **Rules for adjusting entries:** The rules for recording adjusting entries are as follows: every adjusting entry will have one income statement account and one balance sheet account, cash will never be in an adjusting entry, and the adjusting entry records the change in amount that occurred during the period.
- **Posting adjusting entries:** Posting adjusting entries is the same process as posting general journal entries. The additional adjustments may add accounts to the end of the period or may change account balances from the earlier journal entry step in the accounting cycle.

4.4 Use the Ledger Balances to Prepare an Adjusted Trial Balance

- **Adjusted trial balance:** The adjusted trial balance lists all accounts in the general ledger, including adjusting entries, which have nonzero balances. This trial balance is an important step in the accounting process because it helps identify any computational errors throughout the first five steps in the cycle.

4.5 Prepare Financial Statements Using the Adjusted Trial Balance

- **Income Statement:** The income statement shows the net income or loss as a result of revenue and expense activities occurring in a period.
- **Statement of Retained Earnings:** The statement of retained earnings shows the effects of net income (loss) and dividends on the earnings the company maintains.
- **Balance Sheet:** The balance sheet visually represents the accounting equation, showing that assets balance with liabilities and equity.
- **10-column worksheet:** The 10-column worksheet organizes data from the trial balance all the way through the financial statements.



Multiple Choice

1. **LO 4.1** Which of the following is any reporting period shorter than a full year (fiscal or calendar) and can encompass monthly, quarterly, or half-year statements?
 - A. fiscal year
 - B. interim period
 - C. calendar year
 - D. fixed year
2. **LO 4.1** Which of the following is the federal, independent agency that provides oversight of public companies to maintain fair representation of company financial activities for investors to make informed decisions?
 - A. IRS (Internal Revenue Service)
 - B. SEC (Securities and Exchange Commission)
 - C. FASB (Financial Accounting Standards Board)
 - D. FDIC (Federal Deposit Insurance Corporation)
3. **LO 4.1** Revenues and expenses must be recorded in the accounting period in which they were earned or incurred, no matter when cash receipts or outlays occur under which of the following accounting methods?
 - A. accrual basis accounting
 - B. cash basis accounting
 - C. tax basis accounting
 - D. revenue basis accounting
4. **LO 4.1** Which of the following breaks down company financial information into specific time spans, and can cover a month, quarter, half-year, or full year?
 - A. accounting period
 - B. yearly period
 - C. monthly period
 - D. fiscal period
5. **LO 4.1** Which of the following is a twelve-month reporting cycle that can begin in any month, except January 1, and records financial data for that twelve-month consecutive period?
 - A. fixed year
 - B. interim period
 - C. calendar year
 - D. fiscal year
6. **LO 4.2** Which type of adjustment occurs when cash is either collected or paid, but the related income or expense is *not* reportable in the current period?
 - A. accrual
 - B. deferral
 - C. estimate
 - D. cull

7. **L0 4.2** Which type of adjustment occurs when cash is *not* collected or paid, but the related income or expense is reportable in the current period?
- A. accrual
 - B. deferral
 - C. estimate
 - D. cull
8. **L0 4.2** If an adjustment includes an entry to a payable or receivable account, which type of adjustment is it?
- A. accrual
 - B. deferral
 - C. estimate
 - D. cull
9. **L0 4.2** If an adjustment includes an entry to Accumulated Depreciation, which type of adjustment is it?
- A. accrual
 - B. deferral
 - C. estimate
 - D. cull
10. **L0 4.2** Rent collected in advance is an example of which of the following?
- A. accrued expense
 - B. accrued revenue
 - C. deferred expense (prepaid expense)
 - D. deferred revenue (unearned revenue)
11. **L0 4.2** Rent paid in advance is an example of which of the following?
- A. accrued expense
 - B. accrued revenue
 - C. deferred expense (prepaid expense)
 - D. deferred revenue (unearned revenue)
12. **L0 4.2** Salaries owed but *not* yet paid is an example of which of the following?
- A. accrued expense
 - B. accrued revenue
 - C. deferred expense (prepaid expense)
 - D. deferred revenue (unearned revenue)
13. **L0 4.2** Revenue earned but *not* yet collected is an example of which of the following?
- A. accrued expense
 - B. accrued revenue
 - C. deferred expense (prepaid expense)
 - D. deferred revenue (unearned revenue)
14. **L0 4.3** What adjusting journal entry is needed to record depreciation expense for the period?
- A. a debit to Depreciation Expense; a credit to Cash
 - B. a debit to Accumulated Depreciation; a credit to Depreciation Expense
 - C. a debit to Depreciation Expense; a credit to Accumulated Depreciation
 - D. a debit to Accumulated Depreciation; a credit to Cash

15. **LO 4.3** Which of these transactions requires an adjusting entry (debit) to Unearned Revenue?
- A. revenue earned but not yet collected
 - B. revenue collected but not yet earned
 - C. revenue earned before being collected, when it is later collected
 - D. revenue collected before being earned, when it is later earned
16. **LO 4.4** What critical purpose does the adjusted trial balance serve?
- A. It proves that transactions have been posted correctly
 - B. It is the source document from which to prepare the financial statements
 - C. It shows the beginning balances of every account, to be used to start the new year's records
 - D. It proves that all journal entries have been made correctly.
17. **LO 4.4** Which of the following accounts' balance would be a different number on the Balance Sheet than it is on the adjusted trial balance?
- A. accumulated depreciation
 - B. unearned service revenue
 - C. retained earnings
 - D. dividends
18. **LO 4.5** On which financial statement would the Supplies account appear?
- A. Balance Sheet
 - B. Income Statement
 - C. Retained Earnings Statement
 - D. Statement of Cash Flows
19. **LO 4.5** On which financial statement would the Dividends account appear?
- A. Balance Sheet
 - B. Income Statement
 - C. Retained Earnings Statement
 - D. Statement of Cash Flows
20. **LO 4.5** On which financial statement would the Accumulated Depreciation account appear?
- A. Balance Sheet
 - B. Income Statement
 - C. Retained Earnings Statement
 - D. Statement of Cash Flows
21. **LO 4.5** On which two financial statements would the Retained Earnings account appear?
- A. Balance Sheet
 - B. Income Statement
 - C. Retained Earnings Statement
 - D. Statement of Cash Flows



Questions

1. **LO 4.1** Describe the revenue recognition principle. Give specifics.
2. **LO 4.1** Describe the expense recognition principle (matching principle). Give specifics.

3. **LO 4.2** What parts of the accounting cycle require analytical processes, rather than methodical processes? Explain.
4. **LO 4.2** Why is the adjusting process needed?
5. **LO 4.2** Name two types of adjusting journal entries that are commonly made before preparing financial statements? Explain, with examples.
6. **LO 4.2** Are there any accounts that would never have an adjusting entry? Explain.
7. **LO 4.2** Why do adjusting entries always include both balance sheet and income statement accounts?
8. **LO 4.2** Why are adjusting journal entries needed?
9. **LO 4.3** If the Supplies account had an ending balance of \$1,200 and the actual count for the remaining supplies was \$400 at the end of the period, what adjustment would be needed?
10. **LO 4.3** When a company collects cash from customers before performing the contracted service, what is the impact, and how should it be recorded?
11. **LO 4.3** If the Prepaid Insurance account had a balance of \$12,000, representing one year's policy premium, which was paid on July 1, what entry would be needed to adjust the Prepaid Insurance account at the end of December, before preparing the financial statements?
12. **LO 4.3** If adjusting entries include these listed accounts, what other account must be in that entry as well? (A) Depreciation expense; (B) Unearned Service Revenue; (C) Prepaid Insurance; (D) Interest Payable.
13. **LO 4.4** What is the difference between the trial balance and the adjusted trial balance?
14. **LO 4.4** Why is the adjusted trial balance trusted as a reliable source for building the financial statements?
15. **LO 4.5** Indicate on which financial statement the following accounts (from the adjusted trial balance) would appear: (A) Sales Revenue; (B) Unearned Rent Revenue; (C) Prepaid Advertising; (D) Advertising Expense; (E) Dividends; (F) Cash.



Exercise Set A

- EA1. LO 4.2** Identify whether each of the following transactions, which are related to revenue recognition, are accrual, deferral, or neither.
- A. sold goods to customers on credit
 - B. collected cash from customer accounts
 - C. sold goods to customers for cash
 - D. collected cash in advance for goods to be delivered later
- EA2. LO 4.2** Identify whether each of the following transactions, which are related to expense recognition, are accrual, deferral, or neither.
- A. paid an expense for the current month
 - B. prepaid an expense for future months
 - C. made a payment to reduce accounts payable
 - D. incurred a current-month expense, to be paid next month

EA3. **L0 4.2** Identify which type of adjustment is indicated by these transactions. Choose accrued revenue, accrued expense, deferred revenue, or deferred expense.

- A. rent paid in advance for use of property
- B. cash received in advance for future services
- C. supplies inventory purchased
- D. fees earned but not yet collected

EA4. **L0 4.2** The following accounts were used to make year-end adjustments. Identify the related account that is associated with this account (the other account in the adjusting entry).

- A. Salaries Payable
- B. Depreciation Expense
- C. Supplies
- D. Unearned Rent

EA5. **L0 4.2** Reviewing insurance policies revealed that a single policy was purchased on August 1, for one year's coverage, in the amount of \$6,000. There was no previous balance in the Prepaid Insurance account at that time. Based on the information provided:

- A. Make the December 31 adjusting journal entry to bring the balances to correct.
- B. Show the impact that these transactions had.

EA6. **L0 4.3** On July 1, a client paid an advance payment (retainer) of \$5,000 to cover future legal services. During the period, the company completed \$3,500 of the agreed-on services for the client. There was no beginning balance in the Unearned Revenue account for the period. Based on the information provided,

- A. Make the December 31 adjusting journal entry to bring the balances to correct.
- B. Show the impact that these transactions had.

EA7. **L0 4.3** Reviewing payroll records indicates that employee salaries that are due to be paid on January 3 include \$3,575 in wages for the last week of December. There was no previous balance in the Salaries Payable account at that time. Based on the information provided, make the December 31 adjusting journal entry to bring the balances to correct.

EA8. **L0 4.3** Supplies were purchased on January 1, to be used throughout the year, in the amount of \$8,500. On December 31, a physical count revealed that the remaining supplies totaled \$1,200. There was no beginning of the year balance in the Supplies account. Based on the information provided:

- A. Create journal entries for the original transaction
- B. Create journal entries for the December 31 adjustment needed to bring the balances to correct
- C. Show the activity, with ending balance

EA9. **L0 4.3** Prepare journal entries to record the following business transaction and related adjusting entry.

- A. January 12, purchased supplies for cash, to be used all year, \$3,850
- B. December 31, physical count of remaining supplies, \$800

EA10. **L0 4.3** Prepare journal entries to record the following adjustments.

- A. Insurance that expired this period, \$18,000
- B. Depreciation on assets, \$4,800
- C. Salaries earned by employees but unpaid, \$1,200

EA11. **L0 4.3** Prepare adjusting journal entries, as needed, considering the account balances excerpted from the unadjusted trial balance and the adjustment data.

Unadjusted Trial Balance		
Account Title	Debit	Credit
Fixed assets	120,000	
Accumulated depreciation		24,000
Prepaid rent	18,000	
Unearned revenue		3,500

- A. depreciation on fixed assets, \$ 8,500
- B. unexpired prepaid rent, \$12,500
- C. remaining balance of unearned revenue, \$555

EA12. **L0 4.4** Prepare an adjusted trial balance from the following adjusted account balances (assume accounts have normal balances).

Accounts payable	\$ 6,600
Accounts receivable	12,750
Administrative expense	49,150
Cash	28,900
Common stock	15,000
Prepaid insurance	8,800
Service revenue	78,000

EA13. **L0 4.4** Prepare an adjusted trial balance from the following account information, considering the adjustment data provided (assume accounts have normal balances).

Accounts payable	\$11,700
Accounts receivable	17,100
Administrative expense	54,800
Cash	44,800
Common stock	30,000
Prepaid insurance	16,000
Service revenue	91,000

Adjustments needed:

Salaries due to administrative employees, but unpaid at period end, \$2,000

Insurance still unexpired at end of the period, \$12,000

EA14. **L0 4.5** From the following Company A adjusted trial balance, prepare simple financial statements, as follows:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 42,000	
Accounts receivable	11,300	
Prepaid insurance	14,800	
Accounts payable		\$ 10,900
Salaries payable		14,000
Common stock		25,000
Service revenue		61,000
Administrative expenses	42,800	
	110,900	110,900



Exercise Set B

EB1. **L0 4.1** Identify whether each of the following transactions, which are related to revenue recognition, are accrual, deferral, or neither.

- A. provided legal services to client, who paid at the time of service
- B. received cash for legal services performed last month
- C. received cash from clients for future services to be provided
- D. provided legal services to client, to be collected next month

EB2. **L0 4.1** Identify whether each of the following transactions, which are related to expense recognition, are accrual, deferral, or neither.

- A. recorded employee salaries earned, to be paid in future month
- B. paid employees for current month salaries
- C. paid employee salaries for work performed in a prior month
- D. gave an employee an advance on future wages

EB3. **L0 4.2** Indicate what impact the following adjustments have on the accounting equation, Assets = Liabilities + Equity (assume normal balances).

		Impact 1	Impact 2
A.	Prepaid Insurance adjusted from \$5,000 to \$3,600		
B.	Interest Payable adjusted from \$5,300 to \$6,800		
C.	Prepaid Insurance adjusted from \$18,500 to \$6,300		
D.	Supplies account balance \$500, actual count \$220		

Table 4.5

EB4. **L0 4.2** What two accounts are affected by the needed adjusting entries?

- A. supplies actual counts are lower than account balance
- B. employee salaries are due but not paid at year end
- C. insurance premiums that were paid in advance have expired

EB5. **L0 4.3** Reviewing insurance policies revealed that a single policy was purchased on March 1, for one year's coverage, in the amount of \$9,000. There was no previous balance in the Prepaid Insurance account at that time. Based on the information provided,

- A. Make the December 31 adjusting journal entry to bring the balances to correct.
- B. Show the impact that these transactions had.

EB6. **L0 4.3** On September 1, a company received an advance rental payment of \$12,000, to cover six months' rent on an office building. There was no beginning balance in the Unearned Rent account for the period. Based on the information provided,

- A. Make the December 31 adjusting journal entry to bring the balances to correct.
- B. Show the impact that these transactions had.

EB7. **L0 4.3** Reviewing payroll records indicates that one-fifth of employee salaries that are due to be paid on the first payday in January, totaling \$15,000, are actually for hours worked in December. There was no previous balance in the Salaries Payable account at that time. Based on the information provided, make the December 31 adjusting journal entry to bring the balances to correct.

EB8. **L0 4.3** On July 1, a client paid an advance payment (retainer) of \$10,000, to cover future legal services. During the period, the company completed \$6,200 of the agreed-on services for the client. There was no beginning balance in the Unearned Revenue account for the period. Based on the information provided, make the journal entries needed to bring the balances to correct for:

- A. original transaction
- B. December 31 adjustment

EB9. **L0 4.3** Prepare journal entries to record the business transaction and related adjusting entry for the following:

- A. March 1, paid cash for one year premium on insurance contract, \$18,000
- B. December 31, remaining unexpired balance of insurance, \$3,000

EB10. **L0 4.3** Prepare journal entries to record the following adjustments:

- A. revenue earned but not collected, nor recorded, \$14,000
- B. revenue earned that had originally been collected in advance, \$8,500
- C. taxes due but not yet paid, \$ 2,750

EB11. **L0 4.3** Prepare adjusting journal entries, as needed, considering the account balances excerpted from the unadjusted trial balance and the adjustment data.

Unadjusted Trial Balance		
Account Title	Debit	Credit
Equipment	66,000	
Accumulated depreciation		22,000
Supplies	6,000	
Salaries payable		3,500

- A. amount due for employee salaries, \$4,800
- B. actual count of supplies inventory, \$ 2,300
- C. depreciation on equipment, \$3,000

EB12. **L0 4.4** Prepare an adjusted trial balance from the following adjusted account balances (assume accounts have normal balances).

Accounts payable	\$ 22,400
Accounts receivable	45,750
Administrative expense	57,700
Cash	56,500
Common stock	40,000
Prepaid rent	8,750
Revenue	106,300

EB13. **L0 4.4** Prepare an adjusted trial balance from the following account information, considering the adjustment data provided (assume accounts have normal balances).

Accounts payable	\$10,075
Accounts receivable	15,500
Cash	64,575
Common stock	31,000
Fees earned revenue	82,000
Operating expense	38,000
Supplies	5,000

Adjustments needed:

- Physical count of supplies inventory remaining at end of period, \$2,150
- Taxes payable at end of period, \$3,850

EB14. **L0 4.5** From the following Company B adjusted trial balance, prepare simple financial statements, as follows:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 77,800	
Accounts receivable	19,500	
Supplies	7,650	
Accounts payable		\$ 8,500
Taxes payable		5,350
Common stock		35,000
Fees earned revenue		95,300
Operating expense	39,200	
	144,150	144,150



Problem Set A

PA1. **L0 4.1** Identify whether each of the following transactions, which are related to revenue recognition, are accrual, deferral, or neither.

- A. earn now, collect now
- B. earn now, collect later
- C. earn later, collect now

PA2. **L0 4.1** To demonstrate the difference between cash account activity and accrual basis profits (net income), note the amount each transaction affects cash *and* the amount each transaction affects net income.

- A. paid balance due for accounts payable \$6,900
- B. charged clients for legal services provided \$5,200
- C. purchased supplies on account \$1,750
- D. collected legal service fees from clients for current month \$3,700
- E. issued stock in exchange for a note payable \$10,000

PA3. **L0 4.2** Identify which type of adjustment is indicated by these transactions. Choose accrued revenue, accrued expense, deferred revenue, deferred expense, or estimate.

- A. utilities owed but not paid
- B. cash received in advance for future services
- C. supplies inventory purchased
- D. fees earned but not yet collected
- E. depreciation expense recorded
- F. insurance paid for future periods

PA4. **L0 4.2** Identify which type of adjustment is associated with this account, and what is the other account in the adjustment? Choose accrued revenue, accrued expense, deferred revenue, or deferred expense.

- A. accounts receivable
- B. interest payable
- C. prepaid insurance
- D. unearned rent

PA5. **L0 4.2** Indicate what impact the following adjustments have on the accounting equation, Assets = Liabilities + Equity (assume normal balances).

		Impact 1	Impact 2
A.	Unearned Fees adjusted from \$7,000 to \$5,000		
B.	Recorded depreciation expense of \$12,000		
C.	Prepaid Insurance adjusted from \$18,500 to \$6,300		
D.	Supplies account balance \$500, actual count \$220		

Table 4.6

PA6. **L0 4.2** What two accounts are affected by each of these adjustments?

- A. billed customers for services provided
- B. adjusted prepaid insurance to correct
- C. recorded depreciation expense
- D. recorded unpaid utility bill
- E. adjusted supplies inventory to correct

PA7. **L0 4.3** Using the following information:

- A. make the December 31 adjusting journal entry for depreciation
- B. determine the net book value (NBV) of the asset on December 31
 - Cost of asset, \$250,000
 - Accumulated depreciation, beginning of year, \$80,000
 - Current year depreciation, \$25,000

PA8. **L0 4.3** Use the following account T-balances (assume normal balances) and correct balance information to make the December 31 adjusting journal entries.

	T-Account Balance	Correct Balance
Prepaid insurance	\$26,000	\$14,500
Salaries payable	\$5,500	\$6,200
Unearned rental revenue	\$8,000	\$1,600

PA9. **L0 4.3** Use the following account T-balances (assume normal balances) and correct balance information to make the December 31 adjusting journal entries.

	T-Account Balance	Correct Balance
Unearned service revenue	24,000	10,500
Supplies	8,500	2,600
Interest payable	2,400	2,000

PA10. **L0 4.3** Prepare journal entries to record the following transactions. Create a T-account for Interest Payable, post any entries that affect the account, and tally the ending balance for the account (assume Interest Payable beginning balance of \$2,500).

- A. March 1, paid interest due on note, \$2,500
- B. December 31, interest accrued on note payable, \$4,250

PA11. **L0 4.3** Prepare journal entries to record the following transactions. Create a T-account for Prepaid Insurance, post any entries that affect the account, and tally the ending balance for the account (assume Prepaid Insurance beginning balance of \$9,000).

- A. April 1, paid cash for one-year policy, \$18,000
- B. December 31, unexpired premiums, \$4,500

PA12. **L0 4.3** Determine the amount of cash expended for Salaries during the month, based on the entries in the following accounts (assume 0 beginning balances).

Account	Debit	Credit
Salaries Expense		
	55,000	
Balance	55,000	
Salaries Payable		
		6,000
Balance		6,000

PA13. **L0 4.3** Prepare adjusting journal entries, as needed, considering the account balances excerpted from the unadjusted trial balance and the adjustment data.

Unadjusted Trial Balance		
	Debit	Credit
Property plant and equipment	320,000	
Accumulated depreciation		89,500
Prepaid insurance	24,000	
Supplies	7,500	
Unearned service revenue		3,000

- A. supplies actual count at year end, \$6,500
- B. remaining unexpired insurance, \$6,000
- C. remaining unearned service revenue, \$1,200
- D. salaries owed to employees, \$2,400
- E. depreciation on property plant and equipment, \$18,000

PA14. **L0 4.4** Prepare an adjusted trial balance from the adjusted account balances; solve for the one missing account balance: Cash (assume accounts have normal balances).

Accounts payable	\$19,000
Accounts receivable	23,760
Cash	?
Common stock	38,000
Dividends	9,000
Equipment	20,000
Prepaid insurance	21,466
Land	45,000
Notes payable	61,000
Retained earnings	18,815
Insurance expense	19,689
Service revenue	90,550
Supplies	5,250
Salaries expense	51,000

PA15. **L0 4.4** Prepare an adjusted trial balance from the following account information, considering the adjustment data provided (assume accounts have normal balances). Equipment was recently purchased, so there is neither depreciation expense nor accumulated depreciation.

Accounts payable	\$ 9,500
Accounts receivable	14,260
Cash	22,222
Common stock	30,000
Dividends	5,000
Equipment	12,000
Prepaid insurance	25,444
Land	20,000
Notes payable	26,000
Retained earnings	12,815
Insurance expense	12,689
Service revenue	89,550
Supplies	2,750
Salaries expense	53,500

Adjustments needed:

- Salaries due to employees, but unpaid at the end of the period, \$2,000
- Insurance still unexpired at end of the period, \$12,000

PA16. **L0 4.4** Prepare an adjusted trial balance from the following account information, and also considering the adjustment data provided (assume accounts have normal balances). Equipment was recently purchased, so there is neither depreciation expense nor accumulated depreciation.

Accounts payable	\$26,000
Accounts receivable	8,000
Cash	29,000
Common stock	33,000
Dividends	9,000
Equipment	68,000
Notes payable (due next month)	29,000
Salaries expense	42,000
Salaries payable	2,000
Service revenue	75,000
Supplies	5,000
Transportation expense	4,000

Adjustments needed:

- Remaining unpaid Salaries due to employees at the end of the period, \$0
- Accrued Interest Payable at the end of the period, \$7,700

PA17. **L0 4.5** Using the following Company W information, prepare a Retained Earnings Statement.

- Retained earnings balance January 1, 2019, \$43,500
- Net income for year 2019, \$55,289
- Dividends declared and paid for year 2019, \$18,000

PA18. **L0 4.5** From the following Company Y adjusted trial balance, prepare simple financial statements, as follows:

- Income Statement
- Retained Earnings Statement
- Balance Sheet

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 32,000	
Accounts receivable	17,300	
Prepaid insurance	6,400	
Land	10,000	
Accounts payable		\$ 10,900
Salaries payable		6,000
Common stock		31,000
Retained earnings		4,200
Dividends	8,000	
Service revenue		74,000
Insurance expense	5,600	
Salaries expense	24,000	
Miscellaneous expense	22,800	
	126,100	126,100



Problem Set B

PB1. **LO 4.1** Identify whether each of the following transactions, which are related to revenue recognition, are accrual, deferral, or neither.

- A. expense now, pay now
- B. expense later, pay now
- C. expense now, pay later

PB2. **LO 4.1** To demonstrate the difference between cash account activity and accrual basis profits (net income), note the amount each transaction affects cash *and* the amount each transaction affects net income.

- A. issued stock for cash \$20,000
- B. purchased supplies inventory on account \$1,800
- C. paid employee salaries; assume it was current day's expenses \$950
- D. paid note payment to bank (principal only) \$1,200
- E. collected balance on accounts receivable \$4,750

PB3. **LO 4.2** Identify which type of adjustment is indicated by these transactions. Choose accrued revenue, accrued expense, deferred revenue, or deferred expense.

- A. fees earned and billed, but not collected
- B. recorded depreciation expense
- C. fees collected in advance of services
- D. salaries owed but not yet paid
- E. property rentals costs, prepaid for future months
- F. inventory purchased for cash

PB4. **LO 4.2** Identify which type of adjustment is associated with this account, and what the other account is in the adjustment. Choose accrued revenue, accrued expense, deferred revenue, or deferred expense.

- A. Salaries Payable
- B. Interest Receivable
- C. Unearned Fee Revenue
- D. Prepaid Rent

PB5. **LO 4.2** Indicate what impact the following adjustments have on the accounting equation: Assets = Liabilities + Equity (assume normal balances).

		Impact 1	Impact 2
A.	Unearned Rent adjusted from \$15,000 to \$9,500		
B.	Recorded salaries payable of \$3,750		
C.	Prepaid Rent adjusted from \$6,000 to \$4,000		
D.	Recorded depreciation expense of \$5,500		

Table 4.7

PB6. **L0 4.2** What two accounts are affected by each of these adjustments?

- A. recorded accrued interest on note payable
- B. adjusted unearned rent to correct
- C. recorded depreciation for the year
- D. adjusted salaries payable to correct
- E. sold merchandise to customers on account

PB7. **L0 4.3** Using the following information,

- A. Make the December 31 adjusting journal entry for depreciation.
- B. Determine the net book value (NBV) of the asset on December 31.
 - Cost of asset, \$195,000
 - Accumulated depreciation, beginning of year, \$26,000
 - Current year depreciation, \$13,000

PB8. **L0 4.3** Use the following account T-balances (assume normal balances) and correct balance information to make the December 31 adjusting journal entries.

	T-Account Balance	Correct Balance
Unearned fee revenue	\$12,000	\$9,000
Supplies	3,200	1,050
Interest payable	1,850	1,975

PB9. **L0 4.3** Use the following account T-balances (assume normal balances) and correct balance information to make the December 31 adjusting journal entries.

	T-Account Balance	Correct Balance
Prepaid insurance	\$12,000	\$5,000
Taxes payable	8,850	9,900
Unearned rental revenue	6,000	2,000

PB10. **L0 4.3** Prepare journal entries to record the following transactions. Create a T-account for Supplies, post any entries that affect the account, and tally ending balance for the account (assume Supplies beginning balance of \$6,550).

- A. January 26, purchased additional supplies for cash, \$9,500
- B. December 31, actual count of supplies, \$8,500

PB11. **L0 4.3** Prepare journal entries to record the following transactions. Create a T-account for Unearned Revenue, post any entries that affect the account, tally ending balance for the account (assume Unearned Revenue beginning balance of \$12,500).

- A. May 1, collected an advance payment from client, \$15,000
- B. December 31, remaining unearned advances, \$7,500

PB12. **L0** 4.3 Determine the amount of cash expended for Insurance Premiums during the month, based on the entries in the following accounts (assume 0 beginning balances).

Account	Debit	Credit
Insurance Expense		
	31,000	
Balance	31,000	
Prepaid Insurance		
	9,000	
Balance	9,000	

PB13. **L0** 4.3 Prepare adjusting journal entries, as needed, considering the account balances excerpted from the unadjusted trial balance and the adjustment data.

Unadjusted Trial Balance		
	Debit	Credit
Buildings and equipment	250,000	
Accumulated depreciation		56,000
Prepaid advertising	6,400	
Unearned rental revenue		8,900
Interest payable		3,500

- A. depreciation on buildings and equipment, \$17,500
- B. advertising still prepaid at year end, \$2,200
- C. interest due on notes payable, \$4,300
- D. unearned rental revenue, \$6,900
- E. interest receivable on notes receivable, \$1,200

PB14. **L0** 4.4 Prepare an adjusted trial balance from the adjusted account balances; solve for the one missing account balance: Dividends (assume accounts have normal balances). Equipment was recently purchased, so there is neither depreciation expense nor accumulated depreciation.

Accounts payable	\$ 9,000
Accounts receivable	16,032
Cash	20,450
Common stock	24,000
Dividends	?
Equipment	29,000
Prepaid insurance	9,444
Land	34,000
Notes payable	48,000
Retained earnings	31,315
Insurance expense	12,689
Service revenue	82,500
Supplies	9,700
Salaries expense	51,500

PB15. **L0 4.4** Prepare an adjusted trial balance from the following account information, considering the adjustment data provided (assume accounts have normal balances). Building and Equipment were recently purchased, so there is neither depreciation expense nor accumulated depreciation.

Accounts payable	\$ 3,600
Accounts receivable	45,333
Building	156,000
Cash	50,480
Common stock	110,000
Dividends	18,000
Equipment	33,500
Fees earned revenue	225,430
Land	18,000
Supplies expense	5,123
Notes payable	85,500
Retained earnings	60,606
Salaries expense	151,900
Supplies	6,800

Adjustments needed:

- Physical count of supplies inventory remaining at end of period, \$3,300
- Customer fees collected in advance (payments were recorded as Fees Earned), \$18,500

PB16. **L0 4.4** Prepare an adjusted trial balance from the following account information, and also considering the adjustment data provided (assume accounts have normal balances).

Accounts payable	\$ 18,000
Accounts receivable	4,000
Investments	88,000
Cash	19,000
Common stock	30,000
Dividends	16,000
Prepaid insurance	20,000
Insurance expense	8,000
Land	26,000
Notes payable (long term)	55,000
Salaries expense	37,000
Sales revenue	115,000

Adjustments needed:

- Accrued interest revenue on investments at period end, \$2,200
- Insurance still unexpired at end of the period, \$12,000

PB17. **L0 4.5** Using the following Company X information, prepare a Retained Earnings Statement:

- Retained earnings balance January 1, 2019, \$121,500
- Net income for year 2019, \$145,800
- Dividends declared and paid for year 2019, \$53,000

PB18. **LO 4.5** From the following Company Z adjusted trial balance, prepare simple financial statements, as follows:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 54,650	
Accounts receivable	28,750	
Prepaid insurance	8,000	
Land	22,000	
Accounts payable		\$ 14,300
Salaries payable		4,250
Common stock		50,000
Retained earnings		38,900
Dividends	36,000	
Service revenue		257,350
Insurance expense	32,000	
Salaries expense	126,500	
Miscellaneous expense	56,900	
	364,800	364,800



Thought Provokers

TP1. **LO 4.1** Assume you are the controller of a large corporation, and the chief executive officer (CEO) has requested that you explain to them why the net income that you are reporting for the year is so low, when the CEO knows for a fact that the cash accounts are much higher at the end of the year than they were at the beginning of the year. Write a memo to the CEO to offer some possible explanations for the disparity between financial statement net income and the change in cash during the year.

TP2. **LO 4.2** Search the US Securities and Exchange Commission website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>), and locate the latest Form 10-K for a company you would like to analyze. Submit a short memo:

- State the name and ticker symbol of the company you have chosen.
- Review the company's end-of-period Balance Sheet for the most recent annual report, in search of accruals and deferrals.
- List the name and account balance of at least four accounts that represent accruals or deferrals—these could be accrued revenues, accrued expenses, deferred (unearned) revenues, or deferred (prepaid) expenses.
- Provide the web link to the company's Form 10-K, to allow accurate verification of your answers.

TP3. **L0** **4.3** Search the web for instances of possible impropriety relating to earnings management. This could be news reports, Securities and Exchange Commission violation reports, fraud charges, or any other source of alleged financial statement judgement lapse.

- Write down the name and industry type of the company you are discussing.
- Describe the purported indiscretion, and how it relates to mis-reporting earnings or shady accounting.
- Estimate the impact of the potential misrepresented amount.
- Note: You do not have to have proof that a compromise occurred, but you do need to have a source of your reporting of the potential trouble.
- Provide the web link to the information you found, to allow accurate verification of your answers.

TP4. **L0** **4.4** Assume you are employed as the chief financial officer of a corporation and are responsible for preparation of the financial statements, including the adjusting process and preparation of the adjusted trial balance. The company is facing a slow year, and after your adjusting entries, the financial statements are accurately reflecting that fact. However, as you are discussing the matter with your boss, the chief executive officer (CEO), he suggests that you have the power to make further adjustments to the statements, and that you should use that power to “adjust” the profits and equity into a stronger position, so that investor confidence in the company’s prospects will be restored.

Write a short memo to the CEO, stating your intentions about what you can and/or will do to make the financial statements more appealing. Be specific about any planned adjustments that could be made, assuming that normal period-end adjustments have already been reflected accurately in the financial statements that you prepared.

TP5. **L0** **4.5** Search the SEC website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>) and locate the latest Form 10-K for a company you would like to analyze. Submit a short memo:

- State the name and ticker symbol of the company you have chosen.
- Review the company’s end-of-period Balance Sheet, Income Statement, and Statement of Retained Earnings.
- Reconstruct an adjusted trial balance for the company, from the information presented in the three specified financial statements.
- Provide the web link to the company’s Form 10-K, to allow accurate verification of your answers.



5

Completing the Accounting Cycle

Figure 5.1 Mark reviews the financial data from Supreme Cleaners. (credit left: modification of “Numbers and Finance” by “reynermedia”/Flickr, CC BY 2.0; credit right: modification of “Dry cleaned clothes (Unsplash)” by “m0851”/Wikimedia Commons, CC0)

Chapter Outline

- L0 5.1** Describe and Prepare Closing Entries for a Business
- L0 5.2** Prepare a Post-Closing Trial Balance
- L0 5.3** Apply the Results from the Adjusted Trial Balance to Compute Current Ratio and Working Capital Balance, and Explain How These Measures Represent Liquidity
- L0 5.4** Appendix: Complete a Comprehensive Accounting Cycle for a Business



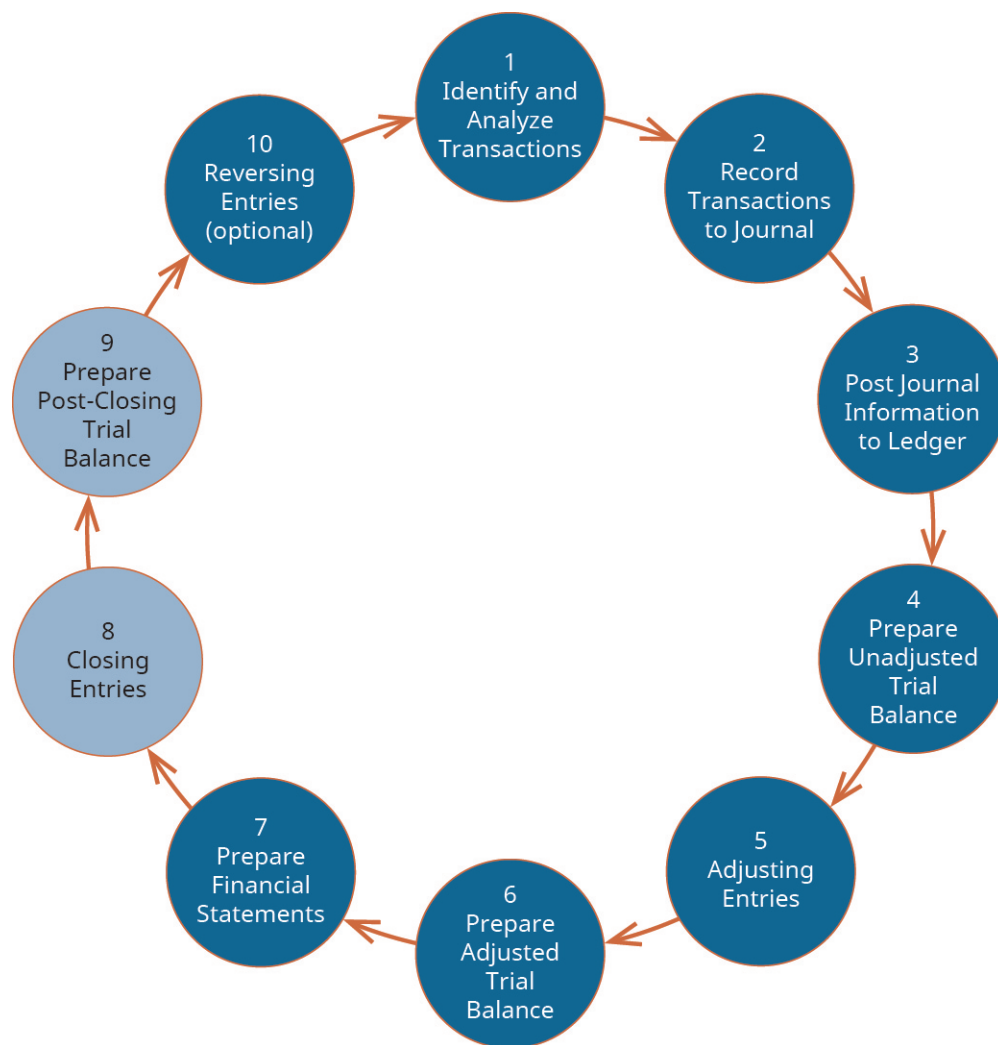
Why It Matters

As we learned in [Analyzing and Recording Transactions](#) and [The Adjustment Process](#), Mark Summers has started his own dry-cleaning business called Supreme Cleaners. Mark had a busy first month of operations, including purchasing equipment and supplies, paying his employees, and providing dry-cleaning services to customers. Because Mark had established a sound accounting system to keep track of his daily transactions, he was able to prepare complete and accurate financial statements showing his company’s progress and financial position.

In order to move forward, Mark needs to review how financial data from his first month of operations transitions into his second month of operations. It is important for Mark to make a smooth transition so he can compare the financials from month to month, and continue on the right path toward growth. It will also assure his investors and lenders that the company is operating as expected. So what does he need to do to prepare for next month?

5.1 Describe and Prepare Closing Entries for a Business

In this chapter, we complete the final steps (steps 8 and 9) of the accounting cycle, the closing process. You will notice that we do not cover step 10, reversing entries. This is an optional step in the accounting cycle that you will learn about in future courses. Steps 1 through 4 were covered in [Analyzing and Recording Transactions](#) and Steps 5 through 7 were covered in [The Adjustment Process](#).



Our discussion here begins with journalizing and posting the closing entries ([Figure 5.2](#)). These posted entries will then translate into a **post-closing trial balance**, which is a trial balance that is prepared after all of the closing entries have been recorded.

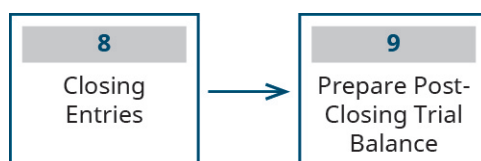


Figure 5.2 Final steps in the accounting cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

THINK IT THROUGH

Should You Compromise to Please Your Supervisor?

You are an accountant for a small event-planning business. The business has been operating for several years but does not have the resources for accounting software. This means you are preparing all steps in the accounting cycle by hand.

It is the end of the month, and you have completed the post-closing trial balance. You notice that there is still a service revenue account balance listed on this trial balance. Why is it considered an error to have a revenue account on the post-closing trial balance? How do you fix this error?

Introduction to the Closing Entries

Companies are required to close their books at the end of each fiscal year so that they can prepare their annual financial statements and tax returns. However, most companies prepare monthly financial statements and close their books annually, so they have a clear picture of company performance during the year, and give users timely information to make decisions.

Closing entries prepare a company for the next accounting period by clearing any outstanding balances in certain accounts that should not transfer over to the next period. **Closing**, or clearing the balances, means returning the account to a zero balance. Having a zero balance in these accounts is important so a company can compare performance across periods, particularly with income. It also helps the company keep thorough records of account balances affecting retained earnings. Revenue, expense, and dividend accounts affect retained earnings and are closed so they can accumulate new balances in the next period, which is an application of the time period assumption.

To further clarify this concept, balances are closed to assure all revenues and expenses are recorded in the proper period and then start over the following period. The revenue and expense accounts should start at zero each period, because we are measuring how much revenue is earned and expenses incurred during the period. However, the cash balances, as well as the other balance sheet accounts, are carried over from the end of a current period to the beginning of the next period.

For example, a store has an inventory account balance of \$100,000. If the store closed at 11:59 p.m. on January 31, 2019, then the inventory balance when it reopened at 12:01 a.m. on February 1, 2019, would still be \$100,000. The balance sheet accounts, such as inventory, would carry over into the next period, in this case February 2019.

The accounts that need to start with a clean or \$0 balance going into the next accounting period are revenue, income, and any dividends from January 2019. To determine the income (profit or loss) from the month of January, the store needs to close the income statement information from January 2019. Zeroing January 2019 would then enable the store to calculate the income (profit or loss) for the next month (February 2019), instead of merging it into January's income and thus providing invalid information solely for the month of February.

However, if the company also wanted to keep year-to-date information from month to month, a separate set of records could be kept as the company progresses through the remaining months in the year. For our purposes, assume that we are closing the books at the end of each month unless otherwise noted.

Let's look at another example to illustrate the point. Assume you own a small landscaping business. It is the end of the year, December 31, 2018, and you are reviewing your financials for the entire year. You see that you earned \$120,000 this year in revenue and had expenses for rent, electricity, cable, internet, gas, and food that totaled \$70,000.

You also review the following information:

	Value December 31
Bank account balance	\$ 7,500
Electronics	3,250
Car	26,545
Furniture	7,200
Credit card balances	9,270
Bank loans	48,350

The next day, January 1, 2019, you get ready for work, but before you go to the office, you decide to review your financials for 2019. What are your year-to-date earnings? So far, you have not worked at all in the current year. What are your total expenses for rent, electricity, cable and internet, gas, and food for the current year? You have also not incurred any expenses yet for rent, electricity, cable, internet, gas or food. This means that the current balance of these accounts is zero, because they were closed on December 31, 2018, to complete the annual accounting period.

Next, you review your assets and liabilities. What is your current bank account balance? What is the current book value of your electronics, car, and furniture? What about your credit card balances and bank loans? Are the value of your assets and liabilities now zero because of the start of a new year? Your car, electronics, and furniture did not suddenly lose all their value, and unfortunately, you still have outstanding debt. Therefore, these accounts still have a balance in the new year, because they are not closed, and the balances are carried forward from December 31 to January 1 to start the new annual accounting period.

This is no different from what will happen to a company at the end of an accounting period. A company will see its revenue and expense accounts set back to zero, but its assets and liabilities will maintain a balance. Stockholders' equity accounts will also maintain their balances. In summary, the accountant resets the temporary accounts to zero by transferring the balances to permanent accounts.

LINK TO LEARNING

Understanding the accounting cycle and preparing trial balances is a practice valued internationally. The Philippines Center for Entrepreneurship and the government of the Philippines hold regular seminars going over this cycle with small business owners. They are also transparent with their internal trial balances in several key government offices. Check out this [article talking about the seminars on the accounting cycle \(https://openstax.org/l/50PhilAcctSem\)](https://openstax.org/l/50PhilAcctSem) and this [public pre-closing trial balance \(https://openstax.org/l/50PhilTrialBal\)](https://openstax.org/l/50PhilTrialBal) presented by the Philippines Department of Health.

Temporary and Permanent Accounts

All accounts can be classified as either permanent (real) or temporary (nominal) ([Figure 5.3](#)).

Permanent (real) accounts are accounts that transfer balances to the next period and include balance sheet accounts, such as assets, liabilities, and stockholders' equity. These accounts will not be set back to zero at the beginning of the next period; they will keep their balances. Permanent accounts are not part of the closing process.

Temporary (nominal) accounts are accounts that are closed at the end of each accounting period, and include income statement, dividends, and income summary accounts. The new account, Income Summary, will be discussed shortly. These accounts are temporary because they keep their balances during the current accounting period and are set back to zero when the period ends. Revenue and expense accounts are closed to Income Summary, and Income Summary and Dividends are closed to the permanent account, Retained Earnings.

	Financial Statement Presented On			Account	
Type of Account	Income Statement	Statement of Retained Earnings	Balance Sheet	Temporary	Permanent
Asset			X		X
Contra Asset			X		X
Liability			X		X
Stockholders' Equity			X		X
Dividends*		X		X	
Revenues	X			X	
Expenses	X			X	

*Contra Stockholders' Equity

Figure 5.3 Location Chart for Financial Statement Accounts. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The **income summary** account is an intermediary between revenues and expenses, and the Retained Earnings account. It stores all of the closing information for revenues and expenses, resulting in a "summary" of income or loss for the period. The balance in the Income Summary account equals the net income or loss for the period. This balance is then transferred to the Retained Earnings account.

Income summary is a nondefined account category. This means that it is not an asset, liability, stockholders' equity, revenue, or expense account. The account has a zero balance throughout the entire accounting period until the closing entries are prepared. Therefore, it will not appear on any trial balances, including the adjusted trial balance, and will not appear on any of the financial statements.

You might be asking yourself, "is the Income Summary account even necessary?" Could we just close out revenues and expenses directly into retained earnings and not have this extra temporary account? We could do this, but by having the Income Summary account, you get a balance for net income a second time. This gives you the balance to compare to the income statement, and allows you to double check that all income statement accounts are closed and have correct amounts. If you put the revenues and expenses directly into retained earnings, you will not see that check figure. No matter which way you choose to close, the same final balance is in retained earnings.

YOUR TURN

Permanent versus Temporary Accounts

Following is a list of accounts. State whether each account is a permanent or temporary account.

- A. rent expense
- B. unearned revenue
- C. accumulated depreciation, vehicle
- D. common stock
- E. fees revenue
- F. dividends
- G. prepaid insurance
- H. accounts payable

Solution

A, E, and F are temporary; B, C, D, G, and H are permanent.

Let's now look at how to prepare closing entries.

Journalizing and Posting Closing Entries

The eighth step in the accounting cycle is preparing closing entries, which includes journalizing and posting the entries to the ledger.

Four entries occur during the closing process. The first entry closes revenue accounts to the Income Summary account. The second entry closes expense accounts to the Income Summary account. The third entry closes the Income Summary account to Retained Earnings. The fourth entry closes the Dividends account to Retained Earnings. The information needed to prepare closing entries comes from the adjusted trial balance.

Let's explore each entry in more detail using Printing Plus's information from [Analyzing and Recording Transactions](#) and [The Adjustment Process](#) as our example. The Printing Plus adjusted trial balance for January 31, 2019, is presented in [Figure 5.4](#).

PRINTING PLUS Adjusted Trial Balance For the Month Ended January 31, 2019		
Account Title	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		10,100
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

Figure 5.4 Adjusted Trial Balance for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The first entry requires revenue accounts close to the Income Summary account. To get a zero balance in a revenue account, the entry will show a debit to revenues and a credit to Income Summary. Printing Plus has \$140 of interest revenue and \$10,100 of service revenue, each with a credit balance on the adjusted trial balance. The closing entry will debit both interest revenue and service revenue, and credit Income Summary.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Interest Revenue Service Revenue Income Summary <i>To close revenue accounts to Income Summary</i>	140 10,100	10,240

The T-accounts after this closing entry would look like the following.

Service Revenue		Interest Revenue	
	5,500 Jan. 10		140 Jan. 31
	2,800 Jan. 17	Jan. 31 Cls. 140	140
	1,200 Jan. 27		<u>0</u>
	600 Jan. 31		
Jan. 31 Cls. 10,100	10,100		
	<u>0</u>		

Income Summary	
	10,240 Jan. 31
	Cls. #1
	Bal. 10,240

Notice that the balances in interest revenue and service revenue are now zero and are ready to accumulate revenues in the next period. The Income Summary account has a credit balance of \$10,240 (the revenue sum).

The second entry requires expense accounts close to the Income Summary account. To get a zero balance in an expense account, the entry will show a credit to expenses and a debit to Income Summary. Printing Plus has \$100 of supplies expense, \$75 of depreciation expense–equipment, \$5,100 of salaries expense, and \$300 of utility expense, each with a debit balance on the adjusted trial balance. The closing entry will credit Supplies Expense, Depreciation Expense–Equipment, Salaries Expense, and Utility Expense, and debit Income Summary.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Income Summary Supplies Expense Depreciation Expense: Equipment Salaries Expense Utility Expense <i>To close expense accounts to Income Summary</i>	5,575	100 75 5,100 300

The T-accounts after this closing entry would look like the following.

Supplies Expense			
Jan. 31	100		
	100	100	Jan. 31 Cls.
	<u>0</u>		

Salaries Expense			
Jan. 20	3,600		
Jan. 31	1,500		
	5,100	5,100	Jan. 31 Cls.
	<u>0</u>		

Depreciation Expense: Equipment			
Jan. 31	75		
	75	75	Jan. 31 Cls.
	<u>0</u>		

Utility Expense			
Jan. 12	300		
	300	300	Jan. 31 Cls.
	<u>0</u>		

Income Summary			
Jan. 31	Cls. #2	5,575	10,240 Jan. 31 Cls. #1
		Bal. 4,665	

Notice that the balances in the expense accounts are now zero and are ready to accumulate expenses in the next period. The Income Summary account has a new credit balance of \$4,665, which is the difference between revenues and expenses ([Figure 5.5](#)). The balance in Income Summary is the same figure as what is reported on Printing Plus's Income Statement.

PRINTING PLUS Income Statement For the Month Ended January 31, 2019			
Revenues			
Interest Revenue	\$	140	
Service Revenue		<u>10,100</u>	
Total Revenues			\$10,240
Expenses			
Supplies Expense		100	
Depreciation Expense: Equipment		75	
Salaries Expense		5,100	
Utility Expense		<u>300</u>	
Total Expenses			<u>5,575</u>
Net Income			<u>\$ 4,665</u>

Figure 5.5 Income Statement for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Why are these two figures the same? The income statement summarizes your income, as does income summary. If both summarize your income in the same period, then they must be equal. If they do not match, then you have an error.

The third entry requires Income Summary to close to the Retained Earnings account. To get a zero balance in the Income Summary account, there are guidelines to consider.

- If the balance in Income Summary before closing is a credit balance, you will debit Income Summary and credit Retained Earnings in the closing entry. This situation occurs when a company has a net income.
- If the balance in Income Summary before closing is a debit balance, you will credit Income Summary and debit Retained Earnings in the closing entry. This situation occurs when a company has a net loss.

Remember that net income will increase retained earnings, and a net loss will decrease retained earnings. The Retained Earnings account increases on the credit side and decreases on the debit side.

Printing Plus has a \$4,665 credit balance in its Income Summary account before closing, so it will debit Income Summary and credit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Income Summary Retained Earnings <i>To close Income Summary to Retained Earnings</i>	4,665	4,665

The T-accounts after this closing entry would look like the following.

Retained Earnings		Income Summary			
	4,665 Jan. 31 Cls. #3	Jan. 31 Cls. #2	5,575	10,240 Jan. 31 Cls. #1	
	Bal. 4,665	Jan. 31 Cls.	4,665	4,665	
				0	

Notice that the Income Summary account is now zero and is ready for use in the next period. The Retained Earnings account balance is currently a credit of \$4,665.

The fourth entry requires Dividends to close to the Retained Earnings account. Remember from your past studies that dividends are not expenses, such as salaries paid to your employees or staff. Instead, declaring and paying dividends is a method utilized by corporations to return part of the profits generated by the company to the owners of the company—in this case, its shareholders.

If dividends were not declared, closing entries would cease at this point. If dividends are declared, to get a zero balance in the Dividends account, the entry will show a credit to Dividends and a debit to Retained Earnings. As you will learn in [Corporation Accounting](#), there are three components to the declaration and payment of dividends. The first part is the date of declaration, which creates the obligation or liability to pay the dividend. The second part is the date of record that determines who receives the dividends, and the third part is the date of payment, which is the date that payments are made. Printing Plus has \$100 of dividends with a debit balance on the adjusted trial balance. The closing entry will credit Dividends and debit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Retained Earnings Dividends <i>To close dividends account to Retained Earnings</i>	100	100

The T-accounts after this closing entry would look like the following.

Retained Earnings				Dividends			
Jan. 31	Cls. #4	100	4,665	Jan. 14	100		
			Jan. 31		100	100	Jan. 31
			Bal. 4,565		0		Cls.

Why was income summary not used in the dividends closing entry? Dividends are not an income statement account. Only income statement accounts help us summarize income, so only income statement accounts should go into income summary.

Remember, dividends are a contra stockholders' equity account. It is contra to retained earnings. If we pay out dividends, it means retained earnings decreases. Retained earnings decreases on the debit side. The remaining balance in Retained Earnings is \$4,565 ([Figure 5.6](#)). This is the same figure found on the statement of retained earnings.

PRINTING PLUS Statement of Retained Earnings For the Month Ended January 31, 2019	
Beginning Retained Earnings (Jan. 1)	\$ 0
Net Income	4,665
Dividends	(100)
Ending Retained Earnings (Jan. 31)	<u>\$4,565</u>

Figure 5.6 Statement of Retained Earnings for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The statement of retained earnings shows the period-ending retained earnings after the closing entries have been posted. When you compare the retained earnings ledger (T-account) to the statement of retained earnings, the figures must match. It is important to understand retained earnings is *not* closed out, it is only updated. Retained Earnings is the only account that appears in the closing entries that does not close. You

should recall from your previous material that retained earnings are the earnings retained by the company over time—not cash flow but earnings. Now that we have closed the temporary accounts, let's review what the post-closing ledger (T-accounts) looks like for Printing Plus.

T-Account Summary

The T-account summary for Printing Plus after closing entries are journalized is presented in [Figure 5.7](#).

Cash			
Jan. 3	20,000	300	Jan. 12
Jan. 9	4,000	100	Jan. 14
Jan. 17	2,800	3,500	Jan. 18
Jan. 23	5,500	3,600	Jan. 20
Bal. 24,800			

Accounts Payable			
Jan. 18	3,500	3,500	Jan. 5
		500	Jan. 30
		Bal. 500	

Salaries Payable			
		1,500	Jan. 31
		Bal. 1,500	

Unearned Revenue			
Jan. 31	600	4,000	Jan. 9
		Bal. 3,400	

Interest Receivable			
Jan. 31	140		
Bal. 140			

Supplies			
Jan. 30	500	100	Jan. 31
Bal. 400			

Equipment			
Jan. 5	3,500		
Bal. 3,500			

Accumulated Depreciation - Equipment			
	75	Jan. 31	
	Bal. 75		

Common Stock		
	20,000	Jan. 3
	Bal. 20,000	

Dividends		
Jan. 14	100	
	100	Jan. 31
		Cls.
0		
=		

Service Revenue		
	5,500	Jan. 10
	2,800	Jan. 17
	1,200	Jan. 27
	600	Jan. 31
Jan. 31	10,100	10,100
Cls.		
0		
=		

Interest Revenue		
	140	Jan. 31
Jan. 31	Cls. 140	140
0		
=		

Supplies Expense		
Jan. 31	100	
	100	Jan. 31
		Cls.
0		
=		

Salaries Expense		
Jan. 20	3,600	
Jan. 31	1,500	
	5,100	Jan. 31
		Cls.
0		
=		

Depreciation Expense - Equipment		
Jan. 31	75	
	75	Jan. 31
		Cls.
0		
=		

Utility Expense		
Jan. 12	300	
	300	Jan. 31
		Cls.
0		
=		

Income Summary			
Jan. 31	5,575	10,240	Jan. 31
Cls. #2			Cls. #1
Jan. 31	4,665	4,665	
Cls.			
		0	
		=	

Retained Earnings			
Jan. 31	100	4,665	Jan. 31
Cls. #4			Cls. #3
		Bal. 4,565	

Figure 5.7 T-Account Summary. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Notice that revenues, expenses, dividends, and income summary all have zero balances. Retained earnings maintains a \$4,565 credit balance. The post-closing T-accounts will be transferred to the post-closing trial

balance, which is step 9 in the accounting cycle.

THINK IT THROUGH

Closing Entries

A company has revenue of \$48,000 and total expenses of \$52,000. What would the third closing entry be? Why?

YOUR TURN

Frasker Corp. Closing Entries

Prepare the closing entries for Frasker Corp. using the adjusted trial balance provided.

FRASKER CORPORATION Adjusted Trial Balance For the Month Ended June 30, 2018			
Cash	\$ 5,840		
Accounts Receivable	6,575		
Prepaid Machine Rental	6,000		
Office Supplies	435		
Accounts Payable		\$ 2,840	
Common Stock		10,000	
Retained Earnings		4,350	
Dividends	15,000		
Fees Earned		22,350	
Salaries Expense	2,970		
Advertising Expense	325		
Machine Rental Expense	1,000		
Office Rent Expense	1,250		
Utility Expense	145		
	<u>\$39,540</u>		<u>\$39,540</u>

Solution

June 30	Fee Earned	\$22,350	
	Income Summary		\$22,350
	<i>To close all income statement accounts with credit balances</i>		
June 30	Income Summary	5,690	
	Salaries Expense		2,970
	Advertising Expense		325
	Machine Rental Expense		1,000
	Office Rent Expense		1,250
	Utilities Expense		145
	<i>To close out all income statement accounts with debit balances</i>		
June 30	Retained Earnings	16,660	
	Income Summary		16,660
	<i>To close out income summary and update retained earnings</i>		
June 30	Retained Earnings	15,000	
	Dividends		15,000
	<i>To close out dividends and update retained earnings</i>		

5.2 Prepare a Post-Closing Trial Balance

The ninth, and typically final, step of the process is to prepare a post-closing trial balance. The word “post” in this instance means “after.” You are preparing a trial balance *after* the closing entries are complete.

Like all trial balances, the post-closing trial balance has the job of verifying that the debit and credit totals are equal. The post-closing trial balance has one additional job that the other trial balances do not have. The post-closing trial balance is also used to double-check that the only accounts with balances after the closing entries are permanent accounts. If there are any temporary accounts on this trial balance, you would know that there was an error in the closing process. This error must be fixed before starting the new period.

The process of preparing the post-closing trial balance is the same as you have done when preparing the unadjusted trial balance and adjusted trial balance. Only permanent account balances should appear on the post-closing trial balance. These balances in post-closing T-accounts are transferred over to either the debit or credit column on the post-closing trial balance. When all accounts have been recorded, total each column and verify the columns equal each other.

The post-closing trial balance for Printing Plus is shown in [Figure 5.8](#).

PRINTING PLUS Post-Closing Trial Balance For the Month Ended January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Retained Earnings		4,565
Total	\$30,040	\$30,040

Figure 5.8 Printing Plus's Post-Closing Trial Balance. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Notice that only permanent accounts are included. All temporary accounts with zero balances were left out of this statement. Unlike previous trial balances, the retained earnings figure is included, which was obtained through the closing process.

At this point, the accounting cycle is complete, and the company can begin a new cycle in the next period. In essence, the company's business is always in operation, while the accounting cycle utilizes the cutoff of month-end to provide financial information to assist and review the operations.

It is worth mentioning that there is one step in the process that a company may or may not include, step 10, reversing entries. Reversing entries reverse an adjusting entry made in a prior period at the start of a new period. We do not cover reversing entries in this chapter, but you might approach the subject in future accounting courses.

Now that we have completed the accounting cycle, let's take a look at another way the adjusted trial balance assists users of information with financial decision-making.

LINK TO LEARNING

If you like quizzes, crossword puzzles, fill-in-the-blank, matching exercise, and word scrambles to help you learn the material in this course, go to [My Accounting Course \(https://openstax.org/l/50MyAcctCourse\)](https://openstax.org/l/50MyAcctCourse) for more. This website covers a variety of accounting topics including financial accounting basics, accounting principles, the accounting cycle, and financial statements, all topics introduced in the early part of this course.

CONCEPTS IN PRACTICE

The Importance of Understanding How to Complete the Accounting Cycle

Many students who enroll in an introductory accounting course do not plan to become accountants. They will work in a variety of jobs in the business field, including managers, sales, and finance. In a real company, most of the mundane work is done by computers. Accounting software can perform such tasks as posting the journal entries recorded, preparing trial balances, and preparing financial statements. Students often ask why they need to do all of these steps by hand in their introductory class, particularly if they are never going to be an accountant. It is very important to understand that no matter what your position, if you work in business you need to be able to read financial statements, interpret them, and know how to use that information to better your business. If you have never followed the full process from beginning to end, you will never understand how one of your decisions can impact the final numbers that appear on your financial statements. You will not understand how your decisions can affect the outcome of your company.

As mentioned previously, once you understand the effect your decisions will have on the bottom line on your income statement and the balances in your balance sheet, you can use accounting software to do all of the mundane, repetitive steps and use your time to evaluate the company based on what the financial statements show. Your stockholders, creditors, and other outside professionals will use your financial statements to evaluate your performance. If you evaluate your numbers as often as monthly, you will be able to identify your strengths and weaknesses before any outsiders see them and make any necessary changes to your plan in the following month.

5.3 Apply the Results from the Adjusted Trial Balance to Compute Current Ratio and Working Capital Balance, and Explain How These Measures Represent Liquidity

In [The Adjustment Process](#), we were introduced to the idea of accrual-basis accounting, where revenues and expenses must be recorded in the accounting period in which they were earned or incurred, no matter when cash receipts or outlays occur. We also discussed cash-basis accounting, where income and expenses are recognized when receipts and disbursements occur. In this chapter, we go into more depth about why a company may choose accrual-basis accounting as opposed to cash-basis accounting.

LINK TO LEARNING

Go to the Internal Revenue Service's website, and look at the [most recently updated Pub 334 Tax Guide for Small Business \(https://openstax.org/l/50IRSPub334\)](https://openstax.org/l/50IRSPub334) to learn more about the rules for income tax preparation for a small business.

Cash Basis versus Accrual Basis Accounting

There are several reasons accrual-basis accounting is preferred to cash-basis accounting. Accrual-basis accounting is required by US generally accepted accounting principles (GAAP), as it typically provides a better sense of the financial well-being of a company. Accrual-based accounting information allows management to analyze a company's progress, and management can use that information to improve their business. Accrual accounting is also used to assist companies in securing financing, because banks will typically require a company to provide accrual-basis financial income statements. The Internal Revenue Service might also require businesses to report using accrual basis information when preparing tax returns. In addition, companies with inventory must use accrual-based accounting for income tax purposes, though there are exceptions to the general rule.

So why might a company use cash-basis accounting? Companies that do not sell stock publicly can use cash-basis instead of accrual-basis accounting for internal-management purposes and externally, as long as the Internal Revenue Service does not prevent them from doing so, and they have no other reasons such as agreements per a bank loan. Cash-basis accounting is a simpler accounting system to use than an accrual-basis accounting system when tracking real-time revenues and expenses.

Let's take a look at one example illustrating why accrual-basis accounting might be preferred to cash-basis accounting.

In the current year, a company had the following transactions:

January to March Transactions

Date	Transaction
Jan. 1	Annual insurance policy purchased for \$6,000 cash
Jan. 8	Sent payment for December's electricity bill, \$135
Jan. 15	Performed services worth \$2,500; customer asked to be billed
Jan. 31	Electricity used during January is estimated at \$110
Feb. 16	Realized you forgot to pay January's rent, so sent two months' rent, \$2,000
Feb. 20	Performed services worth \$2,400; customer asked to be billed
Feb. 28	Electricity used during February is estimated at \$150
Mar. 2	Paid March rent, \$1,000
Mar. 10	Received all money owed from services performed in January and February
Mar. 14	Performed services worth \$2,450. Received \$1,800 cash
Mar. 30	Electricity used during March is estimated at \$145

Table 5.1

IFRS CONNECTION

Issues in Comparing Closing Procedures

Regardless of whether a company uses US GAAP or International Financial Reporting Standards (IFRS), the closing and post-closing processes are the same. However, the results generated by these processes are not the same. These differences can be seen most easily in the ratios formulated from the financial statement information and used to assess various financial qualities of a company.

You have learned about the current ratio, which is used to assess a company's ability to pay debts as they come due. How could the use of IFRS versus US GAAP affect this ratio? US GAAP and IFRS most frequently differ on how certain transactions are measured, or on the timing of measuring and reporting that transaction. You will later learn about this in more detail, but for now we use a difference in inventory measurement to illustrate the effect of the two different sets of standards on the current ratio.

US GAAP allows for three different ways to measure ending inventory balances: first-in, first-out (FIFO); last-in, first-out (LIFO); and weighted average. IFRS only allows for FIFO and weighted average. If the prices of inventory being purchased are rising, the FIFO method will result in a higher value of ending inventory on the Balance Sheet than would the LIFO method.

Think about this in the context of the current ratio. Inventory is one component of current assets: the numerator of the ratio. The higher the current assets (numerator), the higher is the current ratio. Therefore, if you calculated the current ratio for a company that applied US GAAP, and then recalculated the ratio assuming the company used IFRS, you would get not only different numbers for inventory (and other accounts) in the financial statements, but also different numbers for the ratios.

This idea illustrates the impact the application of an accounting standard can have on the results of a company's financial statements and related ratios. Different standards produce different results. Throughout the remainder of this course, you will learn more details about the similarities and differences between US GAAP and IFRS, and how these differences impact financial reporting.

Remember, in a cash-basis system you will record the revenue when the money is received no matter when the service is performed. There was no money received from customers in January or February, so the company, under a cash-basis system, would not show any revenue in those months. In March they received the \$2,500 customers owed from January sales, \$2,400 from customers for February sales, and \$1,800 from cash sales in March. This is a total of \$6,700 cash received from customers in March. Since the cash was received in March, the cash-basis system would record revenue in March.

In accrual accounting, we record the revenue as it is earned. There was \$2,500 worth of service performed in January, so that will show as revenue in January. The \$2,400 earned in February is recorded in February, and the \$2,450 earned in March is recorded as revenue in March. Remember, it does not matter whether or not the cash came in.

For expenses, the cash-basis system is going to record an expense the day the payment leaves company hands. In January, the company purchased an insurance policy. The insurance policy is for the entire year, but since the cash went to the insurance company in January, the company will record the entire amount as an expense in January. The company paid the December electric bill in January. Even though the electricity was used to earn revenue in December, the company will record it as an expense in January. Electricity used in

January, February, and March to help earn revenue in those months will show no expense because the bill has not been paid. The company forgot to pay January's rent in January, so no rent expense is recorded in January. However, in February there is \$2,000 worth of rent expense because the company paid for the two months in February.

Under accrual accounting, expenses are recorded when they are incurred and not when paid. Electricity used in a month to help earn revenue is recorded as an expense in that month whether the bill is paid or not. The same is true for rent expense. Insurance expense is spread out over 12 months, and each month 1/12 of the total insurance cost is expensed. The comparison of cash-basis and accrual-basis income statements is presented in [Figure 5.9](#).

Cash Basis Accounting				Accrual Basis Accounting			
	Jan.	Feb.	Mar.		Jan.	Feb.	Mar.
Revenue	\$ -	\$ -	\$6,700	Revenue	\$2,500	\$2,400	\$2,450
Expenses				Expenses			
Electricity	135	-	-	Electricity	110	150	145
Rent		2,000	1,000	Rent	1,000	1,000	1,000
Insurance	6,000			Insurance	500	500	500
Net income	<u>\$(6,135)</u>	<u>\$(2,000)</u>	<u>\$5,700</u>	Net income	<u>\$ 890</u>	<u>\$ 750</u>	<u>\$ 805</u>

Figure 5.9 Cash Basis versus Accrual Basis Accounting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

CONCEPTS IN PRACTICE

Fundamentals of Financial Ratios

One method used by everyone who evaluates financial statements is to calculate financial ratios. Financial ratios take numbers from your income statements and/or your balance sheet to evaluate important financial outcomes that will impact user decisions.

There are ratios to evaluate your liquidity, solvency, profitability, and efficiency. Liquidity ratios look at your ability to pay the debts that you owe in the near future. Solvency will show if you can pay your bills not only in the short term but also in the long term. Profitability ratios are calculated to see how much profit is being generated from a company's sales. Efficiency ratios will be calculated to see how efficient a company is using its assets in running its business. You will be introduced to these ratios and how to interpret them throughout this course.

Compare the two sets of income statements. The cash-basis system looks as though no revenue was earned in the first two months, and expenses were excessive. Then in March it looks like the company earned a lot of revenue. How realistic is this picture? Now look at the accrual basis figures. Here you see a better picture of what really happened over the three months. Revenues and expenses stayed relatively even across periods.

This comparison can show the dangers of reporting in a cash-basis system. In a cash-basis system, the timing of cash flows can make the business look very profitable one month and not profitable the next. If your company was having a bad year and you do not want to report a loss, just do not pay the bills for the last month of the year and you can suddenly show a profit in a cash-basis system. In an accrual-basis system, it

does not matter if you do not pay the bills, you still need to record the expenses and present an income statement that accurately portrays what is happening in your company. The accrual-basis system lends itself to more transparency and detail in reporting. This detail is carried over into what is known as a classified balance sheet.

The Classified Balance Sheet

A **classified balance sheet** presents information on your balance sheet in a more informative structure, where asset and liability categories are divided into smaller, more detailed sections. Classified balance sheets show more about the makeup of our assets and liabilities, allowing us to better analyze the current health of our company and make future strategic plans.

Assets can be categorized as current; property, plant, and equipment; long-term investments; intangibles; and, if necessary, other assets. As you learned in [Introduction to Financial Statements](#), a *current asset* (also known as a *short-term asset*) is any asset that will be converted to cash, sold, or used up within one year, or one operating cycle, whichever is longer. An **operating cycle** is the amount of time it takes a company to use its cash to provide a product or service and collect payment from the customer ([Figure 5.10](#)). For a merchandising firm that sells inventory, an operating cycle is the time it takes for the firm to use its cash to purchase inventory, sell the inventory, and get its cash back from its customers.



Figure 5.10 Operating Cycle. (credit left: modification of “All Sales Final” by Dan Keck/Flickr, Public Domain; credit center: modification of “Money Wallet Finance” by “Goumbik”/Pixabay, CC0; credit right: modification of “Inventory for Seasonal Decoration” by Mirko Tobias Schäfer/Flickr, CC BY 2.0)

LINK TO LEARNING

Newport News Shipbuilding is an American shipbuilder located in Newport News, Virginia. According to

information provided by the company, the company has designed and built 30 aircraft carriers in the past 75 years. That is 30 carriers in 75 years. **Newport News** constructed the USS *Gerald R. Ford*. It took the company eight years to build the carrier, christening it in 2013. The ship then underwent rigorous testing until it was finally delivered to its home port, Naval Station Norfolk in 2017. That is 12 years after work commenced on the project.

With large shipbuilding projects that take many years to complete, the operating cycle for this type of company could expand beyond a year mark, and **Newport News** would use this longer operating cycle when dividing current and long-term assets and liabilities.

Learn more about [Newport News and its parent company Huntington Ingalls Industries \(https://openstax.org/l/50IngallsShip\)](https://openstax.org/l/50IngallsShip) and see a [time-lapse video of the construction of the carrier \(https://openstax.org/l/50ShipBuilding\)](https://openstax.org/l/50ShipBuilding). You can easily tell the passage of time if you watch the snow come and go in the video.

If an asset does not meet the requirements of a current asset, then it is classified as a long-term asset. It can be further defined as property, plant, and equipment; a long-term investment; or an intangible asset ([Figure 5.11](#)). **Property, plant, and equipment** are tangible assets (those that have a physical presence) held for more than one operating cycle or one year, whichever is longer. A **long-term investment** is stocks, bonds, or other types of investments that management intends to hold for more than one operating cycle or one year, whichever is longer. **Intangible assets** do not have a physical presence but give the company a long-term future benefit. Some examples include patents, copyrights, and trademarks.

Liabilities are classified as either current liabilities or long-term liabilities. Liabilities also use the one year, or one operating cycle, for the cut-off between current and noncurrent. As we first discussed in [Introduction to Financial Statements](#), if the debt is due within one year or one operating cycle, whichever is longer, the liability is a current liability. If the debt is settled outside one year or one operating cycle, whichever is longer, the liability is a **long-term liability**.

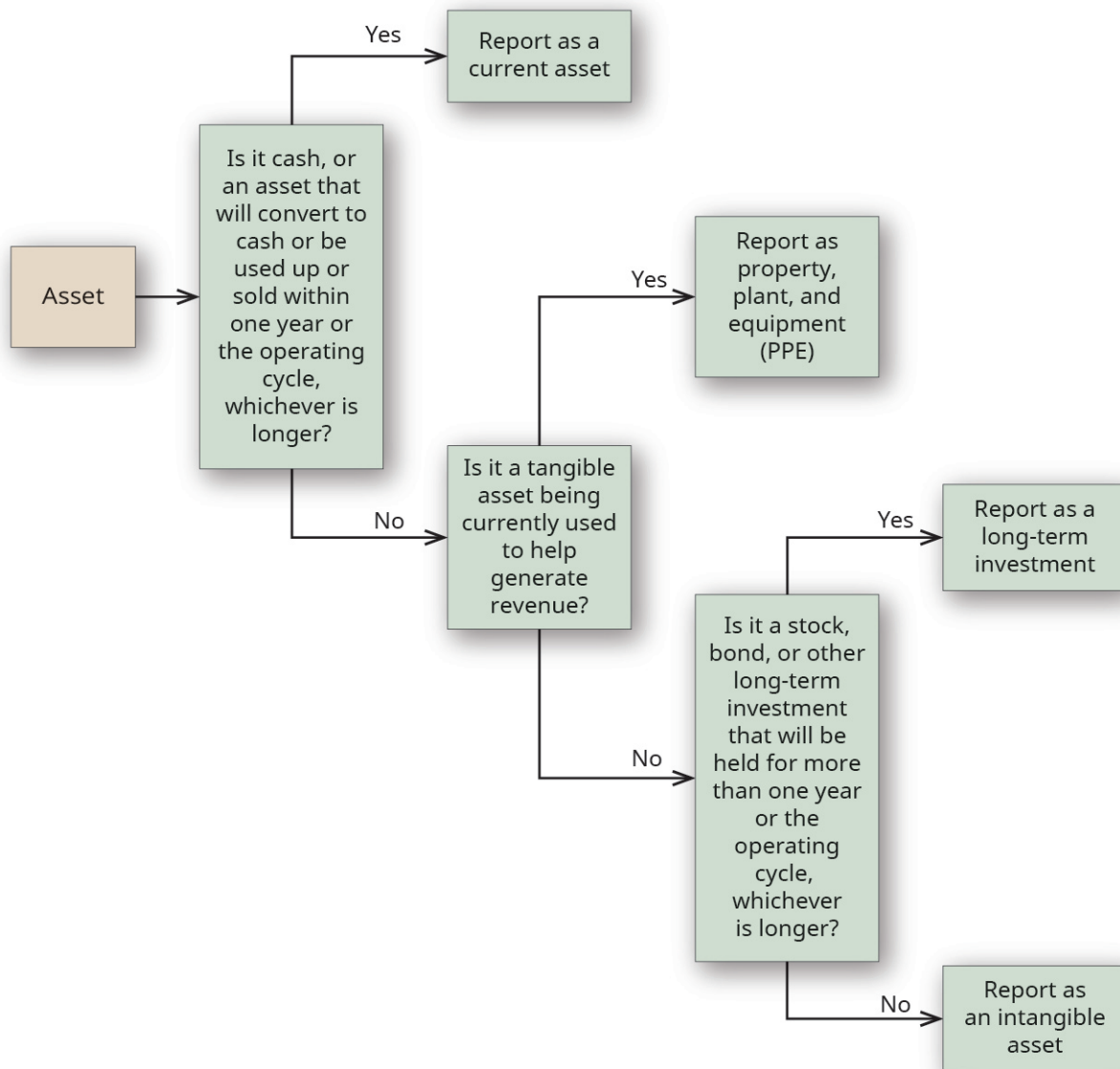


Figure 5.11 Asset Classification Flowchart. A flowchart for asset classification can assist with financial reporting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

YOUR TURN

How to Classify Assets

Classify each of the following assets as current asset; property, plant, and equipment; long-term investment; or intangible asset.

- A. machine
- B. patent
- C. supplies

- D. building
- E. investment in bonds with intent to hold until maturity in 10 years
- F. copyright
- G. land being held for future office
- H. prepaid insurance
- I. accounts receivable
- J. investment in stock that will be held for six months

Solution

A. property, plant, and equipment. B. intangible asset. C. current asset. D. property, plant, and equipment. E. long-term investment. F. intangible asset. G. long-term investment. H. current asset. I. current asset. J. current asset.

The land is considered a long-term investment, because it is not land being used currently by the company to earn revenue. Buying real estate is an investment. If the company decided in the future that it was not going to build the new office, it could sell the land and would probably be able to sell the land for more than it was purchased for, because the value of real estate tends to go up over time. But like any investment, there is the risk that the land might actually go down in value.

The investment in stock that we only plan to hold for six months will be called a marketable security in the current asset section of the balance sheet.

As an example, the balance sheet in [Figure 5.12](#) is classified.

MAGNIFICENT LANDSCAPING SERVICE			
Balance Sheet			
For the Month Ended April 30, 2018			
Assets			
Current Assets			
Cash			\$2,950
Accounts Receivable			575
Office Supplies			40
Prepaid Insurance			240
Total Current Assets			<u>\$3,805</u>
Property, Plant, and Equipment			
Equipment	\$2,500		
Accumulated Depreciation: Equipment	<u>35</u>	2,465	
Total Assets			<u><u>\$6,270</u></u>
Liabilities			
Current Liabilities			
Accounts Payable		\$ 28	
Salaries Payable		420	
Unearned Lawn Mowing Revenue		<u>100</u>	
Total Current Liabilities		\$ 548	
Stockholders' Equity			
Common Stock	\$5,000		
Retained Earnings	<u>722</u>		
Total Stockholders' Equity			<u>5,722</u>
Total Liabilities and Stockholders' Equity			<u><u>\$6,270</u></u>

Figure 5.12 Classified Balance Sheet for Magnificent Landscaping Service. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

CONTINUING APPLICATION AT WORK

Interim Reporting in the Grocery Industry

Interim reporting helps determine how well a company is performing at a given time during the year. Some companies revise their earnings estimates depending on how profitable the company has been up until a certain point in time. The grocery industry, which includes both private and publicly traded companies, performs the same exercise.

However, grocery companies use such information to inform other important business decisions. Consider the last time you walked through the grocery store and purchased your favorite brand but found another item out of stock. What if the next time you shop, the product you loved is no longer carried, but the out-of-stock item is available?

Grocery store profitability is based on small margins of revenue on a multitude of products. The bar codes scanned at checkout not only provide the price of a product but also track how much inventory has been sold. The grocery store analyzes such information to determine how quickly the product turns over,

which drives profit on small margins. If a product sells well, the store might stock it all of the time, but if a product does not sell quickly enough, it could be discontinued.

Using Classified Balance Sheets to Evaluate Liquidity

Categorizing assets and liabilities on a balance sheet helps a company evaluate its business. One way a company can evaluate its business is with financial statement ratios. We consider two measures of liquidity, working capital, and the current ratio. Let's first explore this idea of liquidity.

We first described liquidity in [Introduction to Financial Statements](#) as the ability to convert assets into cash.

Liquidity is a company's ability to convert assets into cash in order to meet short-term cash needs, so it is very important for a company to remain liquid. A critical piece of information to remember at this point is that most companies use the accrual accounting method to determine and maintain their accounting records. This fact means that even with a positive income position, as reflected by its income statement, a company can go bankrupt due to poor cash flow. It is also important to note that even if a company has a lot of cash, it may still be in bankruptcy trouble if all or much of that cash is borrowed. According to an article published in *Money* magazine, one in four small businesses fail because of cash flow issues.^[1] They are making a profit and seem financially healthy but do not have cash when needed.

Companies should analyze liquidity constantly to avoid cash shortages that may result in a need for a short-term loan. Intermittently taking out a short-term loan is often expected, but a company cannot keep coming up short on cash every year if it is going to remain liquid. A seasonal business, such as a specialized holiday retailer, may require a short-term loan to continue its operations during slower revenue-generating periods. Companies will use numbers from their classified balance sheet to test for liquidity. They want to make sure they have enough current assets to pay their current liabilities. Only cash is used to directly pay liabilities, but other current assets, such as accounts receivable or short-term investments, might be sold for cash, converted to cash, or used to bring in cash to pay liabilities.

ETHICAL CONSIDERATIONS

Liquidity Is as Important as Net Worth

How does a company like **Lehman Brothers Holdings**, with over \$639 billion in assets and \$613 billion in liabilities, go bankrupt? That question still confuses many, but it comes down to the fact that having assets recorded on the books at their purchase price is not the same as the immediate value of the assets. **Lehman Brothers** had a liquidity crisis that led to a solvency crisis, because **Lehman Brothers** could not sell the assets on its books at book value to cover its short-term cash demands. Matt Johnston, in an article for the online publication *Coinmonks*, puts it simply: "Liquidity is all about being able to access cash when it's needed. If you can settle your current obligations with ease, you've got liquidity. If you've got debts coming due and you don't have the cash to settle them, then you've got a liquidity crisis."^[2] Continuing this *Coinmonks* discussion, the inability to timely pay debts leads to a business entity

1 Elaine Pofeldt. "5 Ways to Tackle the Problem That Kills One of Every Four Small Businesses." *Money*. May 19, 2015. <http://time.com/money/3888448/cash-flow-small-business-startups/>

becoming insolvent because bills cannot be paid on time and assets need to be written down. When **Lehman Brothers** could not timely pay their bills in 2008, it went bankrupt, sending a shock throughout the entire banking system. Accountants need to understand the differences between net worth, equity, liquidity, and solvency, and be able to inform stakeholders of their organization's actual financial position, not just the recorded numbers on the balance sheet.

Two calculations a company might use to test for liquidity are working capital and the current ratio. **Working capital**, which was first described in [Introduction to Financial Statements](#), is found by taking the difference between current assets and current liabilities.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

A positive outcome means the company has enough current assets available to pay its current liabilities or current debts. A negative outcome means the company does not have enough current assets to cover its current liabilities and may have to arrange short-term financing. Though a positive working capital is preferred, a company needs to make sure that there is not too much of a difference between current assets and current liabilities. A company that has a high working capital might have too much money in current assets that could be used for other company investments. Things such as industry and size of a company will dictate what type of margin is best.

Let's consider Printing Plus and its working capital ([Figure 5.13](#)).

2 Matt Johnson. "Revisiting the Lehman Brothers Collapse, the Business of Banking and Its Inherent Crises." *Coinmonks*. February 1, 2018. <https://medium.com/coinmonks/revisiting-the-lehman-brothers-collapse-fb18769d6cf8>

PRINTING PLUS Balance Sheet For the Month Ended January 31, 2019			
Assets			
Cash			\$24,800
Accounts Receivable			1,200
Interest Receivable			140
Supplies			400
Equipment	\$3,500		
Accumulated Depreciation: Equipment	75	3,425	
Total Assets			<u>\$29,965</u>
Liabilities			
Accounts Payable		\$ 500	
Salaries Payable		1,500	
Unearned Revenue		3,400	
Total Liabilities		5,400	
Stockholders' Equity			
Common Stock		20,000	
Ending Retained Earnings		4,565	
Total Stockholders' Equity		24,565	
Total Liabilities and Stockholders' Equity			<u>\$29,965</u>

Figure 5.13 Balance Sheet for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Printing Plus's current assets include cash, accounts receivable, interest receivable, and supplies. Their current liabilities include accounts payable, salaries payable, and unearned revenue. The following is the computation of working capital:

$$\text{Working capital} = \$26,540 - \$5,400 = \$21,140$$

This means that you have more than enough working capital to pay the current liabilities your company has recorded. This figure may seem high, but remember that this is the company's first month of operations and this much cash may need to be available for larger, long-term asset purchases. However, there is also the possibility that the company might choose to identify long-term financing options for the acquisition of expensive, long-term assets, assuming that it can qualify for the increased debt.

Notice that part of the current liability calculation is unearned revenue. If a company has a surplus of unearned revenue, it can sometimes get away with less working capital, as it will need less cash to pay its bills. However, the company must be careful, since the cash was recorded before providing the services or products associated with the unearned revenue. This relationship is why the unearned revenue was initially created, and there often will be necessary cash outflows associated with meeting the terms of the unearned revenue creation.

Companies with inventory will usually need a higher working capital than a service company, as inventory can tie up a large amount of a company's cash with less cash available to pay its bills. Also, small companies will normally need a higher working capital than larger companies, because it is harder for smaller companies to get loans, and they usually pay a higher interest rate.

LINK TO LEARNING

PricewaterhouseCoopers (PwC) released its [2015 Annual Global Working Capital Survey](https://openstax.org/l/50PwC2015WorCap) (<https://openstax.org/l/50PwC2015WorCap>) which is a detailed study on working capital. Though the report does not show the working capital calculation you just learned, there is very interesting information about working capital in different industries, business sizes, and locations. Take a few minutes and peruse this document.

The **current ratio** (also known as the working capital ratio), which was first described in [Introduction to Financial Statements](#), tells a company how many times over company current assets can cover current liabilities. It is found by dividing current assets by current liabilities and is calculated as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

For example, if a company has current assets of \$20,000 and current liabilities of \$10,000, its current ratio is $\$20,000/\$10,000 = \text{two times}$. This means the company has enough current assets to cover its current liabilities twice. Ideally, many companies would like to maintain a 1.5:2 times current assets over current liabilities ratio. However, depending on the company's function or purpose, an optimal ratio could be lower or higher than the previous recommendation. For example, many utilities do not have large fluctuations in anticipated seasonal current ratios, so they might decide to maintain a current ratio of 1.25:1.5 times current assets over current liabilities ratio, while a high-tech startup might want to maintain a ratio of 2.5:3 times current assets over current liabilities ratio.

The current ratio for Printing Plus is $\$26,540/\$5,400 = 4.91$ times. That is a very high current ratio, but since the business was just started, having more cash might allow the company to make larger purchases while still paying its liabilities. However, this ratio might be a result of short-term conditions, so the company is advised to still plan on maintaining a ratio that is considered both rational and not too risky.

Using ratios for a single year does not provide a broad picture. A company will get much better information if it compares the working capital and current ratio numbers for several years so it can see increases, decreases, and where numbers remain fairly consistent. Companies can also benefit from comparing this financial data to that of other companies in the industry.

ETHICAL CONSIDERATIONS

Computers Still Use Debits and Credits: Check behind the Dashboard for Fraud

Newly hired accountants are often sat at a computer to work off of a dashboard, which is a computer screen where entries are made into the accounting system. New accountants working with modern accounting software may not be aware that their software uses the debit and credit system you learned about, and that the system may automatically close the books without the accountant's review of closing entries. Manually closing the books gives accountants a chance to review the balances of different

accounts; if accountants do not review the entries, they will not know what is occurring in the accounting system or in their organization's financial statements.

Many accounting systems automatically close the books if the command is made in the system. While debits and credits are being entered and may not have been reviewed, the system can be instructed to close out the revenue and expense accounts and create an Income Statement.

A knowledgeable accountant can review entries within the software's audit function. The accountant will be able to look at every entry, its description, both sides of the entry (debit and credit), and any changes made in the entry. This review is important in determining if any incorrect entry was either a mistake or fraud. The accountant can see who made the entry and how the entry occurred in the accounting system.

To ensure the integrity of the system, each person working in the system must have a unique user identification, and no users may know others' passwords. If there is an entry or updated entry, the accountant will be able to see the entry in the audit function of the software. If an employee has changed expense items to pay his or her personal bills, the accountant can see the change. Similarly, changes in transaction dates can be reviewed to determine whether they are fraudulent. Professional accountants know what goes on in their organization's accounting system.

5.4 Appendix: Complete a Comprehensive Accounting Cycle for a Business

We have gone through the entire accounting cycle for Printing Plus with the steps spread over three chapters. Let's go through the complete accounting cycle for another company here. The full accounting cycle diagram is presented in [Figure 5.14](#).

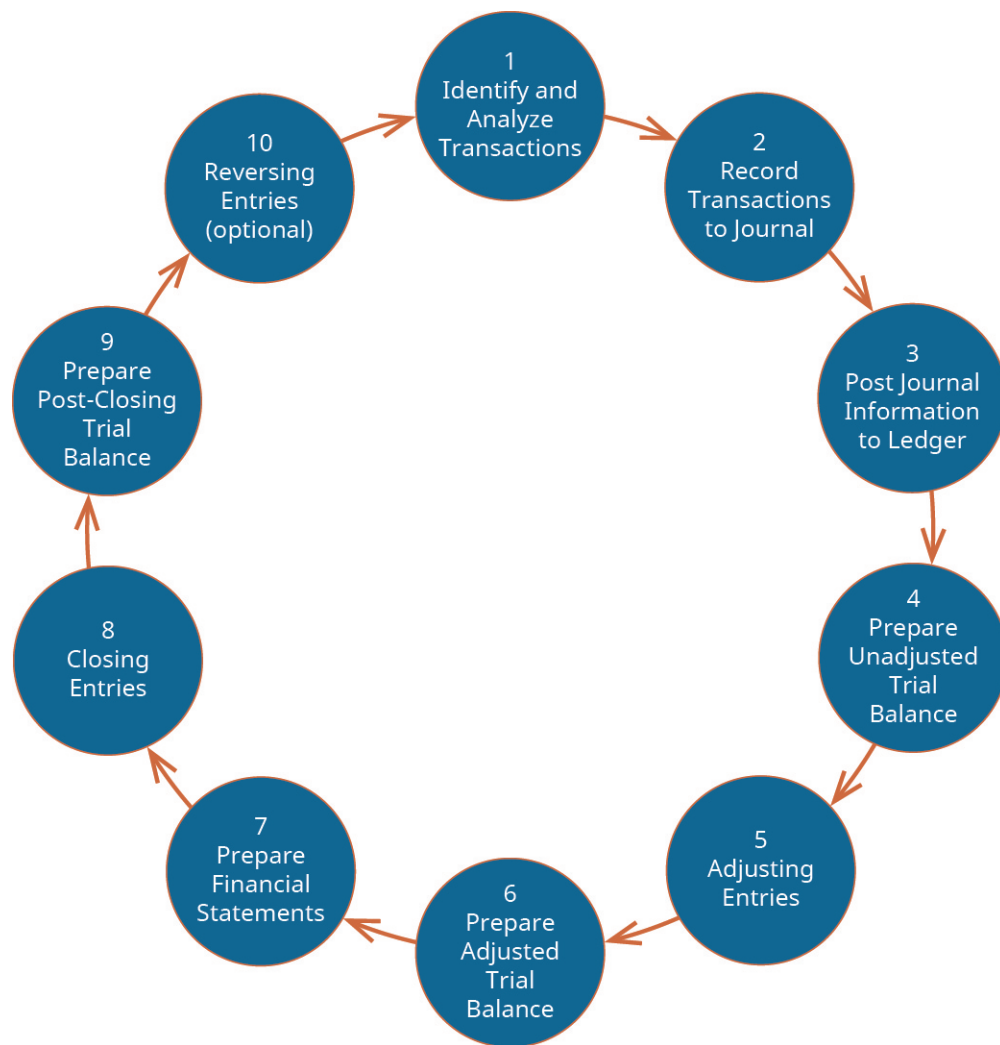


Figure 5.14 The Accounting Cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

We next take a look at a comprehensive example that works through the entire accounting cycle for Clip'em Cliff. Clifford Girard retired from the US Marine Corps after 20 years of active duty. Cliff decides it would be fun to become a barber and open his own shop called "Clip'em Cliff." He will run the barber shop out of his home for the first couple of months while he identifies a new location for his shop.

Since his Marines career included several years of logistics, he is also going to operate a consulting practice where he will help budding barbers create a barbering practice. He will charge a flat fee or a per hour charge. His consulting practice will be recognized as service revenue and will provide additional revenue while he develops his barbering practice.

He obtains a barber's license after the required training and is ready to open his shop on August 1. [Table 5.2](#) shows his transactions from the first month of business.

Transactions for August

Date	Transaction
Aug. 1	Cliff issues \$70,000 shares of common stock for cash.
Aug. 3	Cliff purchases barbering equipment for \$45,000; \$37,500 was paid immediately with cash, and the remaining \$7,500 was billed to Cliff with payment due in 30 days. He decided to buy used equipment, because he was not sure if he truly wanted to run a barber shop. He assumed that he will replace the used equipment with new equipment within a couple of years.
Aug. 6	Cliff purchases supplies for \$300 cash.
Aug. 10	Cliff provides \$4,000 in services to a customer who asks to be billed for the services.
Aug. 13	Cliff pays a \$75 utility bill with cash.
Aug. 14	Cliff receives \$3,200 cash in advance from a customer for services not yet rendered.
Aug. 16	Cliff distributed \$150 cash in dividends to stockholders.
Aug. 17	Cliff receives \$5,200 cash from a customer for services rendered.
Aug. 19	Cliff paid \$2,000 toward the outstanding liability from the August 3 transaction.
Aug. 22	Cliff paid \$4,600 cash in salaries expense to employees.
Aug. 28	The customer from the August 10 transaction pays \$1,500 cash toward Cliff's account.

Table 5.2

Transaction 1: On August 1, 2019, Cliff issues \$70,000 shares of common stock for cash.

Analysis:

- Clip'em Cliff now has more cash. Cash is an asset, which is increasing on the debit side.
- When the company issues stock, this yields a higher common stock figure than before issuance. The common stock account is increasing on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 1, 2019	Cash Common Stock <i>To recognize issuance of common stock</i>	70,000	70,000

Assets	=	Liabilities	+	Stockholders' Equity
+\$70,000	=	+\$0	+	+\$70,000
\$70,000	=	\$0	+	\$70,000

Transaction 2: On August 3, 2019, Cliff purchases barbering equipment for \$45,000; \$37,500 was paid immediately with cash, and the remaining \$7,500 was billed to Cliff with payment due in 30 days.

Analysis:

- Clip'em Cliff now has more equipment than before. Equipment is an asset, which is increasing on the debit side for \$45,000.
- Cash is used to pay for \$37,500. Cash is an asset, decreasing on the credit side.
- Cliff asked to be billed, which means he did not pay cash immediately for \$7,500 of the equipment. Accounts Payable is used to signal this short-term liability. Accounts payable is increasing on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 3, 2019	Equipment Cash Accounts Payable <i>To recognize purchase of equipment</i>	45,000	37,500 7,500

Assets	=	Liabilities	+	Stockholders' Equity
+\$45,000	=	+\$7,500	+	+\$0
-\$37,500				
\$ 7,500	=	\$7,500	+	\$0

Transaction 3: On August 6, 2019, Cliff purchases supplies for \$300 cash.

Analysis:

- Clip'em Cliff now has less cash. Cash is an asset, which is decreasing on the credit side.
- Supplies, an asset account, is increasing on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 6, 2019	Supplies Cash <i>To recognize supplies purchase</i>	300	300

Assets	=	Liabilities	+	Stockholders' Equity
+\$300	=	+\$0	+	+\$0
-\$300				
\$0	=	\$0	+	\$0

Transaction 4: On August 10, 2019, provides \$4,000 in services to a customer who asks to be billed for the services.

Analysis:

- Clip'em Cliff provided service, thus earning revenue. Revenue impacts equity, and increases on the credit side.
- The customer did not pay immediately for the service and owes Cliff payment. This is an Accounts Receivable for Cliff. Accounts Receivable is an asset that is increasing on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 10, 2019	Accounts Receivable Service Revenue <i>To recognize revenue earned, customer purchased on account</i>	4,000	4,000

Assets	=	Liabilities	+	Stockholders' Equity
+\$4,000	=	+\$0	+	+\$4,000
\$4,000	=	\$0	+	\$4,000

Transaction 5: On August 13, 2019, Cliff pays a \$75 utility bill with cash.

Analysis:

- Clip'em Cliff now has less cash than before. Cash is an asset that is decreasing on the credit side.
- Utility payments are billed expenses. Utility Expense negatively impacts equity, and increases on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 13, 2019	Utility Expense Cash <i>To recognize payment of utility bill</i>	75	75

Assets	=	Liabilities	+	Stockholder's Equity
-\$75	=	+\$0	+	-\$75
-\$75	=	\$0	+	-\$75

Transaction 6: On August 14, 2019, Cliff receives \$3,200 cash in advance from a customer for services to be rendered.

Analysis:

- Clip'em Cliff now has more cash. Cash is an asset, which is increasing on the debit side.
- The customer has not yet received services but already paid the company. This means the company owes the customer the service. This creates a liability to the customer, and revenue cannot yet be recognized. Unearned Revenue is the liability account, which is increasing on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 14, 2019	Cash Unearned Revenue <i>To recognize customer's advanced payment</i>	3,200	3,200

Assets	=	Liabilities	+	Stockholders' Equity
+\$3,200	=	+\$3,200	+	+\$0
<u>\$3,200</u>	=	<u>\$3,200</u>	+	<u>\$0</u>

Transaction 7: On August 16, 2019, Cliff distributed \$150 cash in dividends to stockholders.

Analysis:

- Clip'em Cliff now has less cash. Cash is an asset, which is decreasing on the credit side.
- When the company pays out dividends, this decreases equity and increases the dividends account. Dividends increases on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 16, 2019	Dividends Cash <i>To recognize distribution of dividends</i>	150	150

Assets	=	Liabilities	+	Stockholders' Equity
-\$150	=	+\$0	+	-\$150
<u>-\$150</u>	=	<u>\$0</u>	+	<u>-\$150</u>

Transaction 8: On August 17, 2019, Cliff receives \$5,200 cash from a customer for services rendered.

Analysis:

- Clip'em Cliff now has more cash than before. Cash is an asset, which is increasing on the debit side.
- Service was provided, which means revenue can be recognized. Service Revenue increases equity. Service Revenue is increasing on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 17, 2019	Cash Service Revenue <i>To recognize revenue earned</i>	5,200	5,200

Assets	=	Liabilities	+	Stockholders' Equity
+\$5,200	=	+\$0	+	+\$5,200
<u>\$5,200</u>	=	<u>\$0</u>	+	<u>\$5,200</u>

Transaction 9: On August 19, 2019, Cliff paid \$2,000 toward the outstanding liability from the August 3 transaction.

Analysis:

- Clip'em Cliff now has less cash. Cash is an asset, which is decreasing on the credit side.
- Accounts Payable is a liability account, decreasing on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 19, 2019	Accounts Payable Cash <i>To recognize partial payment of liability</i>	2,000	2,000

Assets	=	Liabilities	+	Stockholders' Equity
-\$2,000	=	-\$2,000	+	+\$0
<u>-\$2,000</u>	=	<u>-\$2,000</u>	+	<u>\$0</u>

Transaction 10: On August 22, 2019, Cliff paid \$4,600 cash in salaries expense to employees.

Analysis:

- Clip'em Cliff now has less cash. Cash is an asset, which is decreasing on the credit side.
- When the company pays salaries, this is an expense to the business. Salaries Expense reduces equity by increasing on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 22, 2019	Salaries Expense Cash <i>To recognize employee salary payment</i>	4,600	4,600

Assets	=	Liabilities	+	Stockholders' Equity
-\$4,600	=	+\$0	+	-\$4,600
-\$4,600	=	\$0	+	-\$4,600

Transaction 11: On August 28, 2019, the customer from the August 10 transaction pays \$1,500 cash toward Cliff's account.

Analysis:

- The customer made a partial payment on their outstanding account. This reduces Accounts Receivable. Accounts Receivable is an asset account decreasing on the credit side.
- Cash is an asset, increasing on the debit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 28, 2019	Cash Accounts Receivable <i>To recognize customer partial payment</i>	1,500	1,500

Assets	=	Liabilities	+	Stockholders' Equity
+\$1,500	=	+\$0	+	+\$0
-\$1,500				
\$0	=	\$0	+	\$0

The complete journal for August is presented in [Figure 5.15](#).

JOURNAL			
Date	Account	Debit	Credit
Aug. 1, 2019	Cash Common Stock	70,000	70,000
Aug. 3, 2019	Equipment Cash Account Payable	45,000	37,500 7,500
Aug. 6, 2019	Supplies Cash	300	300
Aug. 10, 2019	Accounts Receivable Service Revenue	4,000	4,000
Aug. 13, 2019	Utility Expense Cash	75	75
Aug. 14, 2019	Cash Unearned Revenue	3,200	3,200
Aug. 16, 2019	Dividends Cash	150	150
Aug. 17, 2019	Cash Service Revenue	5,200	5,200
Aug. 19, 2019	Accounts Payable Cash	2,000	2,000
Aug. 22, 2019	Salaries Expense Cash	4,600	4,600
Aug. 28, 2019	Cash Accounts Receivable	1,500	1,500

Figure 5.15 Journal Entries for August. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Once all journal entries have been created, the next step in the accounting cycle is to post journal information to the ledger. The ledger is visually represented by T-accounts. Cliff will go through each transaction and transfer the account information into the debit or credit side of that ledger account. Any account that has more than one transaction needs to have a final balance calculated. This happens by taking the difference between the debits and credits in an account.

Clip'em Cliff's ledger represented by T-accounts is presented in [Figure 5.16](#).

Cash			
Aug. 1	70,000	37,500	Aug. 3
Aug. 14	3,200	300	Aug. 6
Aug. 17	5,200	75	Aug. 13
Aug. 28	1,500	150	Aug. 16
		2,000	Aug. 19
		4,600	Aug. 22
Bal. 35,275			

Accounts Payable			
Aug. 19	2,000	7,500	Aug. 3
		Bal. 5,500	

Common Stock			
		70,000	Aug. 1
		Bal. 70,000	

Accounts Receivable			
Aug. 10	4,000	1,500	Aug. 28
Bal. 2,500			

Unearned Revenue			
		3,200	Aug. 14
		Bal. 3,200	

Dividends			
Aug. 16	150		
Bal. 150			

Supplies			
Aug. 6	300		
Bal. 300			

Service Revenue			
		4,000	Aug. 10
		5,200	Aug. 17
		Bal. 9,200	

Equipment			
Aug. 3	45,000		
Bal. 45,000			

Salaries Expense			
Aug. 22	4,600		
Bal. 4,600			

Utility Expense			
Aug. 13	75		
Bal. 75			

Figure 5.16 T-Accounts for August. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

You will notice that the sum of the asset account balances in Cliff's ledger equals the sum of the liability and equity account balances at \$83,075. The final debit or credit balance in each account is transferred to the unadjusted trial balance in the corresponding debit or credit column as illustrated in [Figure 5.17](#).

CLIP'EM CLIFF Unadjusted Trial Balance For the Month Ended August 31, 2019		
Account	Debit	Credit
Cash	\$35,275	
Accounts Receivable	2,500	
Supplies	300	
Equipment	45,000	
Accounts Payable		\$ 5,500
Unearned Revenue		3,200
Common Stock		70,000
Dividends	150	
Service Revenue		9,200
Salaries Expense	4,600	
Utility Expense	75	
Total	<u>\$87,900</u>	<u>\$87,900</u>

Service Revenue		
	4,000	Aug. 10
	5,200	Aug. 17
		Bal. 9,200

Salaries Expense		
Aug. 22	4,600	
		Bal. 4,600

Figure 5.17 Unadjusted Trial Balance for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Once all of the account balances are transferred to the correct columns, each column is totaled. The total in the debit column must match the total in the credit column to remain balanced. The unadjusted trial balance for Clip'em Cliff appears in [Figure 5.18](#).

CLIP'EM CLIFF Unadjusted Trial Balance For the Month Ended August 31, 2019		
Account	Debit	Credit
Cash	\$35,275	
Accounts Receivable	2,500	
Supplies	300	
Equipment	45,000	
Accounts Payable		\$ 5,500
Unearned Revenue		3,200
Common Stock		70,000
Dividends	150	
Service Revenue		9,200
Salaries Expense	4,600	
Utility Expense	75	
Total	<u>\$87,900</u>	<u>\$87,900</u>

Figure 5.18 Unadjusted Trial Balance for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The unadjusted trial balance shows a debit and credit balance of \$87,900. Remember, the unadjusted trial balance is prepared before any period-end adjustments are made.

On August 31, Cliff has the transactions shown in [Table 5.3](#) requiring adjustment.

August 31 Transactions

Date	Transaction
Aug. 31	Cliff took an inventory of supplies and discovered that \$250 of supplies remain unused at the end of the month.
Aug. 31	The equipment purchased on August 3 depreciated \$2,500 during the month of August.
Aug. 31	Clip'em Cliff performed \$1,100 of services during August for the customer from the August 14 transaction.
Aug. 31	Reviewing the company bank statement, Clip'em Cliff discovers \$350 of interest earned during the month of August that was previously uncollected and unrecorded. As a new customer for the bank, the interest was paid by a bank that offered an above-market-average interest rate.
Aug. 31	Unpaid and previously unrecorded income taxes for the month are \$3,400. The tax payment was to cover his federal quarterly estimated income taxes. He lives in a state that does not have an individual income tax

Table 5.3

Adjusting Transaction 1: Cliff took an inventory of supplies and discovered that \$250 of supplies remain unused at the end of the month.

Analysis:

- \$250 of supplies remain at the end of August. The company began the month with \$300 worth of supplies. Therefore, \$50 of supplies were used during the month and must be recorded ($300 - 250$). Supplies is an asset that is decreasing (credit).
- Supplies is a type of prepaid expense, that when used, becomes an expense. Supplies Expense would increase (debit) for the \$50 of supplies used during August.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Supplies Expense Supplies <i>To recognize supply usage for August</i>	50	50

Assets	=	Liabilities	+	Stockholders' Equity
-\$50	=	+\$0	+	-\$50
-\$50	=	\$0	+	-\$50

Adjusting Transaction 2: The equipment purchased on August 3 depreciated \$2,500 during the month of August.

Analysis:

- Equipment cost of \$2,500 was allocated during August. This depreciation will affect the Accumulated Depreciation–Equipment account and the Depreciation Expense–Equipment account. While we are not

doing depreciation calculations here, you will come across more complex calculations, such as depreciation in [Long-Term Assets](#).

- Accumulated Depreciation–Equipment is a contra asset account (contrary to Equipment) and increases (credit) for \$2,500.
- Depreciation Expense–Equipment is an expense account that is increasing (debit) for \$2,500.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Depreciation Expense - Equipment Accumulated Depreciation - Equipment <i>To recognize equipment depreciation for August</i>	2,500	2,500

Assets	=	Liabilities	+	Stockholders' Equity
-\$2,500	=	+\$0	+	-\$2,500
-\$2,500	=	\$0	+	-\$2,500

Adjusting Transaction 3: Clip'em Cliff performed \$1,100 of services during August for the customer from the August 14 transaction.

Analysis:

- The customer from the August 14 transaction gave the company \$3,200 in advanced payment for services. By the end of August the company had earned \$1,100 of the advanced payment. This means that the company still has yet to provide \$2,100 in services to that customer.
- Since some of the unearned revenue is now earned, Unearned Revenue would decrease. Unearned Revenue is a liability account and decreases on the debit side.
- The company can now recognize the \$1,100 as earned revenue. Service Revenue increases (credit) for \$1,100.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Unearned Revenue Service Revenue <i>To recognize revenue earned from Aug. 14 transaction</i>	1,100	1,100

Assets	=	Liabilities	+	Stockholders' Equity
\$0	=	-\$1,100	+	+\$1,100
\$0	=	-\$1,100	+	\$1,100

Adjusting Transaction 4: Reviewing the company bank statement, Clip'em Cliff identifies \$350 of interest earned during the month of August that was previously unrecorded.

Analysis:

- Interest is revenue for the company on money kept in a money market account at the bank. The company only sees the bank statement at the end of the month and needs to record as received interest revenue reflected on the bank statement.

- Interest Revenue is a revenue account that increases (credit) for \$350.
- Since Clip'em Cliff has yet to collect this interest revenue, it is considered a receivable. Interest Receivable increases (debit) for \$350.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Interest Receivable Interest Revenue <i>To recognize interest revenue earned but not yet collected</i>	350	350

Assets	=	Liabilities	+	Stockholders' Equity
+\$350	=	\$0	+	+\$350
+\$350	=	\$0	+	+\$350

Adjusting Transaction 5: Unpaid and previously unrecorded income taxes for the month are \$3,400.

Analysis:

- Income taxes are an expense to the business that accumulate during the period but are only paid at predetermined times throughout the year. This period did not require payment but did accumulate income tax.
- Income Tax Expense is an expense account that negatively affects equity. Income Tax Expense increases on the debit side.
- The company owes the tax money but has not yet paid, signaling a liability. Income Tax Payable is a liability that is increasing on the credit side.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Income Tax Expense Income Tax Payable <i>To recognize taxes incurred but not yet paid</i>	3,400	3,400

Assets	=	Liabilities	+	Stockholders' Equity
\$0	=	+\$3,400	+	-\$3,400
\$0	=	\$3,400	+	-\$3,400

The summary of adjusting journal entries for Clip'em Cliff is presented in [Figure 5.19](#).

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Supplies Expense Supplies	50	50
Aug. 31, 2019	Depreciation Expense: Equipment Accumulated Depreciation: Equipment	2,500	2,500
Aug. 31, 2019	Unearned Revenue Service Revenue	1,100	1,100
Aug. 31, 2019	Interest Receivable Interest Revenue	350	350
Aug. 31, 2019	Income Tax Expense Income Tax Payable	3,400	3,400

Figure 5.19 Adjusting Journal Entries for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Now that all of the adjusting entries are journalized, they must be posted to the ledger. Posting adjusting entries is the same process as posting the general journal entries. Each journalized account figure will transfer to the corresponding ledger account on either the debit or credit side as illustrated in [Figure 5.20](#).

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Supplies Expense Supplies	50	50

Supplies			
Aug. 6	300	50	Aug. 31
Bal. 250			

Supplies Expense			
Aug. 31	50		
Bal. 50			

Figure 5.20 Posting Ledger Entries for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

We would normally use a general ledger, but for illustrative purposes, we are using T-accounts to represent the ledgers. The T-accounts after the adjusting entries are posted are presented in [Figure 5.21](#).

Cash		
Aug. 1 70,000	37,500	Aug. 3
Aug. 14 3,200	300	Aug. 6
Aug. 17 5,200	75	Aug. 13
Aug. 28 1,500	150	Aug. 16
	2,000	Aug. 19
	4,600	Aug. 22
Bal. 35,275		

Accounts Payable		
Aug. 19 2,000	7,500	Aug. 3
Bal. 5,500		

Common Stock		
	70,000	Aug. 1
Bal. 70,000		

Accounts Receivable		
Aug. 10 4,000	1,500	Aug. 28
Bal. 2,500		

Unearned Revenue		
Aug. 31 1,100	3,200	Aug. 14
Bal. 2,100		

Dividends		
Aug. 16 150		
Bal. 150		

Interest Receivable		
Aug. 31 350		
Bal. 350		

Income Tax Payable		
	3,400	Aug. 31
Bal. 3,400		

Service Revenue		
	4,000	Aug. 10
	5,200	Aug. 17
	1,100	Aug. 31
Bal. 10,300		

Supplies		
Aug. 6 300	50	Aug. 31
Bal. 250		

Interest Revenue		
	350	Aug. 31
Bal. 350		

Equipment		
Aug. 3 45,000		
Bal. 45,000		

Salaries Expense		
Aug. 22 4,600		
Bal. 4,600		

Accumulated Depreciation: Equipment		
	2,500	Aug. 31
Bal. 2,500		

Utility Expense		
Aug. 13 75		
Bal. 75		

Supplies Expense		
Aug. 31 50		
Bal. 50		

Depreciation Expense: Equipment		
Aug. 31 2,500		
Bal. 2,500		

Income Tax Expense		
Aug. 31 3,400		
Bal. 3,400		

Figure 5.21 Ledger Entries (in T-Accounts) for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

You will notice that the sum of the asset account balances equals the sum of the liability and equity account balances at \$80,875. The final debit or credit balance in each account is transferred to the adjusted trial balance, the same way the general ledger transferred to the unadjusted trial balance.

The next step in the cycle is to prepare the adjusted trial balance. Clip'em Cliff's adjusted trial balance is shown in [Figure 5.22](#).

CLIP'EM CLIFF Adjusted Trial Balance For the Month Ended August 31, 2019		
Account	Debit	Credit
Cash	\$35,275	
Accounts Receivable	2,500	
Interest Receivable	350	
Supplies	250	
Equipment	45,000	
Accumulated Depreciation: Equipment		\$ 2,500
Accounts Payable		5,500
Unearned Revenue		2,100
Income Tax Payable		3,400
Common Stock		70,000
Dividends	150	
Interest Revenue		350
Service Revenue		10,300
Supplies Expense	50	
Depreciation Expense: Equipment	2,500	
Income Tax Expense	3,400	
Salaries Expense	4,600	
Utility Expense	75	
Total	<u>\$94,150</u>	<u>\$94,150</u>

Figure 5.22 Adjusted Trial Balance for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The adjusted trial balance shows a debit and credit balance of \$94,150. Once the adjusted trial balance is prepared, Cliff can prepare his financial statements (step 7 in the cycle). We only prepare the income statement, statement of retained earnings, and the balance sheet. The statement of cash flows is discussed in detail in [Statement of Cash Flows](#).

To prepare your financial statements, you want to work with your adjusted trial balance.

Remember, revenues and expenses go on an income statement. Dividends, net income (loss), and retained earnings balances go on the statement of retained earnings. On a balance sheet you find assets, contra assets, liabilities, and stockholders' equity accounts.

The income statement for Clip'em Cliff is shown in [Figure 5.23](#).

CLIP'EM CLIFF Income Statement For the Month Ended August 31, 2019		
Revenues		
Interest Revenue	\$ 350	
Service Revenue	<u>10,300</u>	
Total Revenues		\$10,650
Expenses		
Supplies Expense	50	
Depreciation Expense: Equipment	2,500	
Salaries Expense	4,600	
Utility Expense	75	
Income Tax Expense	<u>3,400</u>	
Total Expenses		<u>10,625</u>
Net Income		<u>\$ 25</u>

Figure 5.23 Income Statement for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Note that expenses were only \$25 less than revenues. For the first month of operations, Cliff welcomes any income. Cliff will want to increase income in the next period to show growth for investors and lenders.

Next, Cliff prepares the following statement of retained earnings ([Figure 5.24](#)).

CLIP'EM CLIFF Statement of Retained Earnings For the Month Ended August 31, 2019	
Beginning Retained Earnings (Aug. 1)	\$ 0
Net Income	<u>25</u>
Dividends	(150)
Ending Retained Earnings (Aug. 31)	<u><u>\$(125)</u></u>

Figure 5.24 Statement of Retained Earnings for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The beginning retained earnings balance is zero because Cliff just began operations and does not have a balance to carry over to a future period. The ending retained earnings balance is -\$125. You probably never want to have a negative value on your retained earnings statement, but this situation is not totally unusual for an organization in its initial operations. Cliff will want to improve this outcome going forward. It might make sense for Cliff to not pay dividends until he increases his net income.

Cliff then prepares the balance sheet for Clip'em Cliff as shown in [Figure 5.25](#).

CLIP'EM CLIFF Balance Sheet For the Month Ended August 31, 2019			
Assets			
Cash			\$35,275
Accounts Receivable			2,500
Interest Receivable			350
Supplies			250
Equipment	\$45,000		
Accumulated Depreciation: Equipment	<u>2,500</u>	42,500	
Total Assets			<u>\$80,875</u>
Liabilities			
Accounts Payable		\$ 5,500	
Income Tax Payable		3,400	
Unearned Revenue		<u>2,100</u>	
Total Liabilities		11,000	
Stockholders' Equity			
Common Stock		70,000	
Ending Retained Earnings		<u>(125)</u>	
Total Stockholders' Equity		69,875	
Total Liabilities and Stockholders' Equity			<u>\$80,875</u>

Figure 5.25 Balance Sheet for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The balance sheet shows total assets of \$80,875, which equals total liabilities and equity. Now that the financial statements are complete, Cliff will go to the next step in the accounting cycle, preparing and posting closing entries. To do this, Cliff needs his adjusted trial balance information.

Cliff will only close temporary accounts, which include revenues, expenses, income summary, and dividends. The first entry closes revenue accounts to income summary. To close revenues, Cliff will debit revenue accounts and credit income summary.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Service Revenue	10,300	
	Interest Revenue	350	
	Income Summary		10,650
	<i>To close revenue accounts to Income Summary</i>		

The second entry closes expense accounts to income summary. To close expenses, Cliff will credit expense accounts and debit income summary.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Income Summary Supplies Expense Depreciation Expense: Equipment Income Tax Expense Salaries Expense Utility Expense <i>To close expense accounts to Income Summary</i>	10,625	50 2,500 3,400 4,600 75

The third entry closes income summary to retained earnings. To find the balance, take the difference between the income summary amount in the first and second entries (10,650 – 10,625). To close income summary, Cliff would debit Income Summary and credit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Income Summary Retained Earnings <i>To close Income Summary to Retained Earnings</i>	25	25

The fourth closing entry closes dividends to retained earnings. To close dividends, Cliff will credit Dividends, and debit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Aug. 31, 2019	Retained Earnings Dividends <i>To close Dividends to Retained Earnings</i>	150	150

Once all of the closing entries are journalized, Cliff will post this information to the ledger. The closed accounts with their final balances, as well as Retained Earnings, are presented in [Figure 5.26](#).

Dividends			
Aug. 16	150	150	Aug. 31 cls.
Bal. 0			

Supplies Expense			
Aug. 31	50	50	Aug. 31 cls.
Bal. 0			

Service Revenue			
Aug. 31 cls.	10,300	4,000	Aug. 10
		5,200	Aug. 17
		1,100	Aug. 31
		Bal. 0	

Depreciation Expense: Equipment			
Aug. 31	2,500	2,500	Aug. 31 cls.
Bal. 0			

Interest Revenue			
Aug. 31 cls.	350	350	Aug. 31
		Bal. 0	

Income Tax Expense			
Aug. 31	3,400	3,400	Aug. 31 cls.
Bal. 0			

Salaries Expense			
Aug. 22	4,600	4,600	Aug. 31 cls.
Bal. 0			

Income Summary			
Aug. 31 cls. #2	10,625	10,650	Aug. 31 cls. #1
Aug. 31 cls. #3	25	25	
Bal. 0			

Utility Expense			
Aug. 13	75	75	Aug. 31 cls.
Bal. 0			

Retained Earnings			
Aug. 31 cls. #4	150	25	Aug. 31 cls. #3
Bal. 125			

Figure 5.26 Closed Accounts with Final Balances for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Now that the temporary accounts are closed, they are ready for accumulation in the next period.

The last step for the month of August is step 9, preparing the post-closing trial balance. The post-closing trial balance should only contain permanent account information. No temporary accounts should appear on this trial balance. Clip'em Cliff's post-closing trial balance is presented in [Figure 5.27](#).

CLIP'EM CLIFF Post-closing Trial Balance For the Month Ended August 31, 2019		
Account	Debit	Credit
Cash	\$35,275	
Accounts Receivable	2,500	
Interest Receivable	350	
Supplies	250	
Equipment	45,000	
Accumulated Depreciation: Equipment		\$ 2,500
Accounts Payable		5,500
Unearned Revenue		2,100
Income Tax Payable		3,400
Common Stock		70,000
Retained Earnings	125	
Total	<u>\$83,500</u>	<u>\$83,500</u>

Figure 5.27 Post-Closing Trial Balance for Clip'em Cliff. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

At this point, Cliff has completed the accounting cycle for August. He is now ready to begin the process again for September, and future periods.

CONCEPTS IN PRACTICE

Reversing Entries

One step in the accounting cycle that we did not cover is reversing entries. Reversing entries can be made at the beginning of a new period to certain accruals. The company will reverse adjusting entries made in the prior period to the revenue and expense accruals.

It can be difficult to keep track of accruals from prior periods, as support documentation may not be readily available in current or future periods. This requires an accountant to remember when these accruals came from. By reversing these accruals, there is a reduced risk for counting revenues and expenses twice. The support documentation received in the current or future period for an accrual will be easier to match to prior revenues and expenses with the reversal.

LINK TO LEARNING

As we have learned, the current ratio shows how well a company can cover short-term debt with short-term assets. Look through the [balance sheet in the 2017 Annual Report for Target \(https://openstax.org/l/50Target2017Bal\)](https://openstax.org/l/50Target2017Bal) and calculate the current ratio. What does the outcome mean for Target?

THINK IT THROUGH

Using Liquidity Ratios to Evaluate Financial Performance

You own a landscaping business that has just begun operations. You made several expensive equipment purchases in your first month to get your business started. These purchases very much reduced your cash-on-hand, and in turn your liquidity suffered in the following months with a low working capital and current ratio.

Your business is now in its eighth month of operation, and while you are starting to see a growth in sales, you are not seeing a significant change in your working capital or current ratio from the low numbers in your early months. What could you attribute to this stagnancy in liquidity? Is there anything you can do as a business owner to better these liquidity measurements? What will happen if you cannot change your liquidity or it gets worse?

Key Terms

classified balance sheet presents information on your balance sheet in a more informative structure, where asset and liability categories are divided into smaller, more detailed sections

closing returning the account to a zero balance

closing entry prepares a company for the next accounting period by clearing any outstanding balances in certain accounts that should not transfer over to the next period

current ratio current assets divided by current liabilities; used to determine a company's liquidity (ability to meet short-term obligations)

income summary intermediary between revenues and expenses, and the Retained Earnings account, storing all the closing information for revenues and expenses, resulting in a "summary" of income or loss for the period

intangible asset asset with financial value but no physical presence; examples include copyrights, patents, goodwill, and trademarks

liquidity ability to convert assets into cash in order to meet primarily short-term cash needs or emergencies

long-term investment stocks, bonds, or other types of investments held for more than one operating cycle or one year, whichever is longer

long-term liability debt settled outside one year or one operating cycle, whichever is longer

operating cycle amount of time it takes a company to use its cash to provide a product or service and collect payment from the customer

permanent (real) account account that transfers balances to the next period, and includes balance sheet accounts, such as assets, liabilities, and stockholder's equity

post-closing trial balance trial balance that is prepared after all the closing entries have been recorded

property, plant, and equipment tangible assets (those that have a physical presence) held for more than one operating cycle or one year, whichever is longer

temporary (nominal) account account that is closed at the end of each accounting period, and includes income statement, dividends, and income summary accounts

working capital current assets less current liabilities; sometimes used as a measure of liquidity

Summary

5.1 Describe and Prepare Closing Entries for a Business

- Closing entries: Closing entries prepare a company for the next period and zero out balance in temporary accounts.
- Purpose of closing entries: Closing entries are necessary because they help a company review income accumulation during a period, and verify data figures found on the adjusted trial balance.
- Permanent accounts: Permanent accounts do not close and are accounts that transfer balances to the next period. They include balance sheet accounts, such as assets, liabilities, and stockholder's equity
- Temporary accounts: Temporary accounts are closed at the end of each accounting period and include income statement, dividends, and income summary accounts.
- Income Summary: The Income Summary account is an intermediary between revenues and expenses, and the Retained Earnings account. It stores all the closing information for revenues and expenses, resulting in a "summary" of income or loss for the period.
- Recording closing entries: There are four closing entries; closing revenues to income summary, closing expenses to income summary, closing income summary to retained earnings, and close dividends to

retained earnings.

- Posting closing entries: Once all closing entries are complete, the information is transferred to the general ledger T-accounts. Balances in temporary accounts will show a zero balance.

5.2 Prepare a Post-Closing Trial Balance

- Post-closing trial balance: The post-closing trial balance is prepared after closing entries have been posted to the ledger. This trial balance only includes permanent accounts.

5.3 Apply the Results from the Adjusted Trial Balance to Compute Current Ratio and Working Capital Balance, and Explain How These Measures Represent Liquidity

- Cash-basis versus accrual-basis system: The cash-basis system delays revenue and expense recognition until cash is collected, which can mislead investors about the daily operations of a business. The accrual-basis system recognizes revenues and expenses in the period in which they were earned or incurred, allowing for an even distribution of income and a more accurate business of daily operations.
- Classified balance sheet: The classified balance sheet breaks down assets and liabilities into subcategories focusing on current and long-term classifications. This allows investors to see company position in both the short term and long term.
- Liquidity: Liquidity means a business has enough cash available to pay bills as they come due. Being too liquid can mean that a company is not using its assets efficiently.
- Working capital: Working capital shows how efficiently a company operates. The formula is current assets minus current liabilities.
- Current ratio: The current ratio shows how many times over a company can cover its liabilities. It is found by dividing current assets by current liabilities.

5.4 Appendix: Complete a Comprehensive Accounting Cycle for a Business

- The comprehensive accounting cycle is the process in which transactions are recorded in the accounting records and are ultimately reflected in the ending period balances on the financial statements.
- Comprehensive accounting cycle for a business: A service business is taken through the comprehensive accounting cycle, starting with the formation of the entity, recording all necessary journal entries for its transactions, making all required adjusting and closing journal entries, and culminating in the preparation of all requisite financial statements



Multiple Choice

1. **LO 5.1** Which of the following accounts is considered a temporary or nominal account?

- A. Fees Earned Revenue
- B. Prepaid Advertising
- C. Unearned Service Revenue
- D. Prepaid Insurance

2. **LO 5.1** Which of the following accounts is considered a permanent or real account?

- A. Interest Revenue
- B. Prepaid Insurance
- C. Insurance Expense
- D. Supplies Expense

3. **L0 5.1** If a journal entry includes a debit or credit to the Cash account, it is most likely which of the following?
- A. a closing entry
 - B. an adjusting entry
 - C. an ordinary transaction entry
 - D. outside of the accounting cycle
4. **L0 5.1** If a journal entry includes a debit or credit to the Retained Earnings account, it is most likely which of the following?
- A. a closing entry
 - B. an adjusting entry
 - C. an ordinary transaction entry
 - D. outside of the accounting cycle
5. **L0 5.1** Which of these accounts would be present in the closing entries?
- A. Dividends
 - B. Accounts Receivable
 - C. Unearned Service Revenue
 - D. Sales Tax Payable
6. **L0 5.1** Which of these accounts would *not* be present in the closing entries?
- A. Utilities Expense
 - B. Fees Earned Revenue
 - C. Insurance Expense
 - D. Dividends Payable
7. **L0 5.1** Which of these accounts is *never* closed?
- A. Dividends
 - B. Retained Earnings
 - C. Service Fee Revenue
 - D. Income Summary
8. **L0 5.1** Which of these accounts is *never* closed?
- A. Prepaid Rent
 - B. Income Summary
 - C. Rent Revenue
 - D. Rent Expense
9. **L0 5.1** Which account would be credited when closing the account for fees earned for the year?
- A. Accounts Receivable
 - B. Fees Earned Revenue
 - C. Unearned Fee Revenue
 - D. Income Summary
10. **L0 5.1** Which account would be credited when closing the account for rent expense for the year?
- A. Prepaid Rent
 - B. Rent Expense
 - C. Rent Revenue
 - D. Unearned Rent Revenue

11. **L0 5.2** Which of these accounts is included in the post-closing trial balance?
- A. Sales Revenue
 - B. Salaries Expense
 - C. Retained Earnings
 - D. Dividends
12. **L0 5.2** Which of these accounts is *not* included in the post-closing trial balance?
- A. Land
 - B. Notes Payable
 - C. Retained Earnings
 - D. Dividends
13. **L0 5.2** On which of the following would the year-end Retained Earnings balance be stated correctly?
- A. Unadjusted Trial Balance
 - B. Adjusted Trial Balance
 - C. Post-Closing Trial Balance
 - D. The Worksheet
14. **L0 5.2** Which of these accounts is included in the post-closing trial balance?
- A. Supplies Expense
 - B. Accounts Payable
 - C. Sales Revenue
 - D. Insurance Expense
15. **L0 5.3** If current assets are \$112,000 and current liabilities are \$56,000, what is the current ratio?
- A. 200 percent
 - B. 50 percent
 - C. 2.0
 - D. \$50,000
16. **L0 5.3** If current assets are \$100,000 and current liabilities are \$42,000, what is the working capital?
- A. 200 percent
 - B. 50 percent
 - C. 2.0
 - D. \$58,000



Questions

1. **L0 5.1** Explain what is meant by the term *real accounts* (also known as permanent accounts).
2. **L0 5.1** Explain what is meant by the term *nominal accounts* (also known as temporary accounts).
3. **L0 5.1** What is the purpose of the closing entries?
4. **L0 5.1** What would happen if the company failed to make closing entries at the end of the year?
5. **L0 5.1** Which of these account types (Assets, Liabilities, Equity, Revenue, Expense, Dividend) are credited in the closing entries? Why?

6. **LO 5.1** Which of these account types (Assets, Liabilities, Equity, Revenue, Expense, Dividend) are debited in the closing entries? Why?
7. **LO 5.1** The account called Income Summary is often used in the closing entries. Explain this account's purpose and how it is used.
8. **LO 5.1** What are the four entries required for closing, assuming that the Income Summary account is used?
9. **LO 5.1** After the first two closing entries are made, Income Summary has a credit balance of \$125,500. What does this indicate about the company's net income or loss?
10. **LO 5.1** After the first two closing entries are made, Income Summary has a debit balance of \$22,750. What does this indicate about the company's net income or loss?
11. **LO 5.2** What account types are included in a post-closing trial balance?
12. **LO 5.2** Which of the basic financial statements can be directly tied to the post-closing trial balance? Why is this so?
13. **LO 5.3** Describe the calculation required to compute working capital. Explain the significance.
14. **LO 5.3** Describe the calculation required to compute the current ratio. Explain the significance.
15. **LO 5.4** Describe the progression of the three trial balances that a company would have during the period, and explain the difference between the three.



Exercise Set A

- EA1. LO 5.1** Identify whether each of the following accounts is nominal/temporary or real/permanent.
- A. Accounts Receivable
 - B. Fees Earned Revenue
 - C. Utility Expense
 - D. Prepaid Rent
- EA2. LO 5.1** For each of the following accounts, identify whether it is nominal/temporary or real/permanent, and whether it is reported on the Balance Sheet or the Income Statement.
- A. Interest Expense
 - B. Buildings
 - C. Interest Payable
 - D. Unearned Rent Revenue

EA3. LO 5.1 For each of the following accounts, identify whether it would be closed at year-end (yes or no) and on which financial statement the account would be reported (Balance Sheet, Income Statement, or Retained Earnings Statement).

- A. Accounts Payable
- B. Accounts Receivable
- C. Cash
- D. Dividends
- E. Fees Earned Revenue
- F. Insurance Expense
- G. Prepaid Insurance
- H. Supplies

EA4. LO 5.1 The following accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Advertising expense	\$ 5,600
Dividends	4,000
Rent expense	6,000
Salaries expense	48,000
Service revenue	85,000
Utilities expense	7,500

EA5. LO 5.1 The following accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Retained earnings	\$22,000
Dividends	6,000
Fees earned revenue	90,000
Selling expenses	45,000
Administrative expenses	16,000
Miscellaneous expense	2,300

EA6. LO 5.1 Use the following excerpts from the year-end Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Dividends	\$24,000	
Sales Revenue		\$194,000
Automobile Expense	15,500	
Insurance Expense	30,000	
Salaries Expense	96,000	
Supplies Expense	6,500	

EA7. **L0** 5.1 Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Cash	
Bal. 75,000	
Service Revenue	
	Bal. 220,000
Advertising Expense	
Bal. 12,000	
Rent Expense	
Bal. 18,000	
Salaries Expense	
Bal. 120,000	
Dividends	
Bal. 25,000	
Retained Earnings	
	Bal. 30,000

EA8. **L0** 5.1 Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Cash	
Bal. 23,300	
Revenue Earned	
	Bal. 43,000
Commission Expense	
Bal. 6,000	
Supplies Expense	
Bal. 3,200	
Wages Expense	
Bal. 28,000	
Dividends	
Bal. 4,000	
Retained Earnings	
	Bal. 21,500

EA9. **L0 5.2** Identify whether each of the following accounts would be listed in the company's Post-Closing Trial Balance.

- A. Accounts Payable
- B. Advertising Expense
- C. Dividends
- D. Fees Earned Revenue
- E. Prepaid Advertising
- F. Supplies
- G. Supplies Expense
- H. Unearned Fee Revenue

EA10. **L0 5.2** Identify which of the following accounts would *not* be listed on the company's Post-Closing Trial Balance.

Prepaid insurance	\$ 9,444
Land	34,000
Notes payable	48,000
Retained earnings	31,315
Insurance expense	12,689
Service revenue	82,500
Supplies	9,700
Salaries expense	51,500

EA11. **L0 5.3** For each of the following accounts, identify in which section of the classified balance sheet it would be presented: current assets, property, intangibles, other assets, current liabilities, long-term liabilities, or stockholder's equity.

- A. Accounts Payable
- B. Accounts Receivable
- C. Cash
- D. Equipment
- E. Land
- F. Notes Payable (due two years later)
- G. Prepaid Insurance
- H. Supplies

EA12. **L0 5.3** Using the following Balance Sheet summary information, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Current assets	\$76,000	\$295,000
Current liabilities	48,000	163,500

EA13. **L0 5.3** Using the following account balances, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Accounts payable	\$2,000	\$ 6,120
Accounts receivable	3,000	8,450
Cash	4,500	18,600
Prepaid advertising	1,200	4,000
Utilities payable	950	6,500
Wages payable	1,675	8,600

EA14. **L0 5.3** Using the following Balance Sheet summary information, calculate for the two companies presented:

- A. working capital
- B. current ratio

Then:

- A. evaluate which company's liquidity position appears stronger, and why.

	Company J	Company K
Current assets	\$158,500	\$122,000
Current liabilities	141,000	104,000

EA15. **L0 5.3** Using the following account balances, calculate:

- A. working capital
- B. current ratio

	Debit	Credit
Cash	\$ 27,000	
Accounts Receivable	7,300	
Prepaid Insurance	17,000	
Accounts Payable		\$ 14,900
Salaries Payable		16,200
Common Stock		12,000
Service Revenue		66,000
Administrative Expenses	57,800	
	<u>\$109,100</u>	<u>\$109,100</u>



Exercise Set B

EB1. **L0 5.1** Identify whether each of the following accounts are nominal/temporary or real/permanent.

- A. Rent Expense
- B. Unearned Service Fee Revenue
- C. Interest Revenue
- D. Accounts Payable

EB2. **L0 5.1** For each of the following accounts, identify whether it is nominal/temporary or real/permanent, and whether it is reported on the Balance Sheet or the Income Statement.

- A. Salaries Payable
- B. Sales Revenue
- C. Salaries Expense
- D. Prepaid Insurance

EB3. **L0 5.1** For each of the following accounts, identify whether it would be closed at year-end (yes or no) and on which financial statement the account would be reported (Balance Sheet, Income Statement, or Retained Earnings Statement).

- A. Retained Earnings
- B. Prepaid Rent
- C. Rent Expense
- D. Rent Revenue
- E. Salaries Expense
- F. Salaries Payable
- G. Supplies Expense
- H. Unearned Rent Revenue

EB4. **L0 5.1** The following accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Automobile expense	\$ 9,000
Dividends	6,000
Insurance expense	7,500
Office expense	14,000
Sales revenue	120,000
Wage expenses	60,000

EB5. **L0 5.1** The following accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Retained earnings	\$ 78,500
Dividends	12,500
Fees earned revenue	195,000
Selling expenses	101,000
Administrative expenses	46,500
Miscellaneous expense	3,600

EB6. **L0 5.1** Use the following excerpts from the year-end Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Dividends	\$ 20,000	
Service Revenue		\$225,000
Advertising Expense	18,000	
Rent Expense	30,000	
Utilities Expense	6,600	
Wages Expense	148,000	

EB7. **L0** 5.1 Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Cash	
Bal. 35,580	
Sales Revenue	
	Bal. 146,000
Advertising Expense	
Bal. 24,000	
Insurance Expense	
Bal. 18,000	
Salaries Expense	
Bal. 90,000	
Dividends	
Bal. 5,000	
Retained Earnings	
	Bal. 26,580

EB8. **L0** 5.1 Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Cash	
Bal. 25,222	
Rent Revenue	
	Bal. 112,000
Advertising Expense	
Bal. 6,000	
Insurance Expense	
Bal. 12,000	
Salaries Expense	
Bal. 75,000	
Dividends	
Bal. 16,000	
Retained Earnings	
	Bal. 22,222

EB9. **L0** 5.2 Identify which of the following accounts would be listed on the company's Post-Closing Trial Balance.

- A. Accounts Receivable
- B. Accumulated Depreciation
- C. Cash
- D. Office Expense
- E. Note Payable
- F. Rent Revenue
- G. Retained Earnings
- H. Unearned Rent Revenue

EB10. **L0** 5.2 Identify which of the following accounts would *not* be listed on the company's Post-Closing Trial Balance.

Accounts payable	\$19,000
Advertising expense	23,760
Cash	55,332
Common stock	38,000
Dividends	9,000
Fee revenue	60,000
Prepaid insurance	21,466
Land	45,000

EB11. **L0** 5.3 For each of the following accounts, identify in which section of the classified balance sheet it would be presented: current assets, property, intangibles, other assets, current liabilities, long-term liabilities, or stockholder's equity.

- A. Building
- B. Cash
- C. Common Stock
- D. Copyright
- E. Prepaid Advertising
- F. Notes Payable (due six months later)
- G. Taxes Payable
- H. Unearned Rent Revenue

EB12. **L0** 5.3 Using the following Balance Sheet summary information, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Current assets	\$366,500	\$132,000
Current liabilities	120,000	141,500

EB13. **L0 5.3** Using the following account balances, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Accounts payable	\$45,000	\$12,600
Accounts receivable	52,000	15,200
Cash	11,500	19,780
Prepaid insurance	1,060	2,400
Salaries payable	9,400	12,800
Utilities payable	3,500	2,550

EB14. **L0 5.3** Using the following Balance Sheet summary information, calculate for the two companies presented:

- A. working capital
- B. current ratio

Then:

- A. evaluate which company's liquidity position appears stronger, and why.

	Company L	Company M
Current assets	\$425,000	\$215,500
Current liabilities	335,000	132,700

EB15. **L0 5.3** From the following Company B adjusted trial balance, prepare simple financial statements, as follows:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 35,300	
Accounts Receivable	16,750	
Supplies	12,650	
Accounts Payable		\$ 20,850
Tax Payable		3,000
Common Stock		30,000
Fee Earned Revenue		92,550
Operating Expense	81,700	
	<u>\$146,400</u>	<u>\$146,400</u>



Problem Set A

PA1. **LO 5.1** Identify whether each of the following accounts would be considered a permanent account (yes/no) and which financial statement it would be reported on (Balance Sheet, Income Statement, or Retained Earnings Statement).

- A. Accumulated Depreciation
- B. Buildings
- C. Depreciation Expense
- D. Equipment
- E. Fees Earned Revenue
- F. Insurance Expense
- G. Prepaid Insurance
- H. Supplies Expense
- I. Dividends

PA2. **LO 5.1** The following selected accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Accounts receivable	\$45,000
Prepaid insurance	4,500
Land	50,000
Accounts payable	39,000
Notes payable	55,000
Retained earnings	12,000
Dividends	2,000
Fees earned revenue	65,000
Selling expenses	34,500
Administrative expenses	12,750
Miscellaneous expense	1,250

PA3. **LO 5.1** The following selected accounts and normal balances existed at year-end. Notice that *expenses exceed revenue* in this period. Make the four journal entries required to close the books:

Accounts receivable	\$46,200
Prepaid insurance	5,800
Land	12,000
Accounts payable	29,900
Notes payable	32,500
Retained earnings	55,400
Dividends	8,000
Fees earned revenue	89,200
Selling expenses	62,000
Administrative expenses	29,500
Miscellaneous expense	4,140

PA4. **L0 5.1** Use the following Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 38,750	
Prepaid Insurance	4,500	
Equipment	35,000	
Notes Payable		\$ 32,000
Common Stock		10,000
Retained Earnings		17,325
Dividends	22,000	
Sales Revenue		200,000
Automobile Expense	24,575	
Insurance Expense	18,000	
Salaries Expense	110,000	
Supplies Expense	6,500	
	<u>\$259,325</u>	<u>\$259,325</u>

PA5. **L0 5.1** Use the following Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 22,900	
Prepaid Insurance	4,000	
Fixed Assets	44,000	
Notes Payable		\$ 40,000
Common Stock		25,000
Retained Earnings		48,350
Dividends	22,000	
Sales Revenue		150,000
Automobile Expense	26,500	
Insurance Expense	20,000	
Salaries Expense	122,500	
Supplies Expense	1,450	
	<u>\$263,350</u>	<u>\$263,350</u>

PA6. **L0 5.1** Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Accounts Receivable	
Bal. 45,500	
Fees Earned Revenue	
	Bal. 60,000
Commission Expense	
Bal. 7,200	
Supplies Expense	
Bal. 5,500	
Wages Expense	
Bal. 42,000	
Dividends	
Bal. 3,500	
Retained Earnings	
	Bal. 51,000

PA7. **L0 5.1** Assume that the first two closing entries have been made and posted. Use the T-accounts provided as follows to:

- complete the closing entries
- determine the ending balance in the Retained Earnings account

Debit	Credit
Income Summary	
212,000	277,500
Retained Earnings	
	Bal. 45,900
Dividends	
Bal. 7,500	

PA8. **L0 5.1** Correct any obvious errors in the following closing entries by providing the four corrected closing entries. Assume all accounts held normal account balances in the Adjusted Trial Balance.

A.

Income Summary	\$280,000	
Service Revenue		\$280,000

B.

Automobile Expense	\$ 16,500	
Insurance Expense	24,000	
Salaries Expense	190,000	
Supplies Expense	18,500	
Income Summary		\$249,000

C.

Retained Earnings	\$263,500	
Income Summary		\$263,500

D.

Dividends	\$10,000	
Retained Earnings		\$10,000

PA9. **L0 5.2** Assuming the following Adjusted Trial Balance, create the Post-Closing Trial Balance that would result, after all closing journal entries were made and posted:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 22,900	
Prepaid Insurance	4,000	
Fixed Assets	44,000	
Notes Payable		\$ 40,000
Common Stock		25,000
Retained Earnings		48,350
Dividends	22,000	
Sales Revenue		150,000
Automobile Expense	26,500	
Insurance Expense	20,000	
Salaries Expense	122,500	
Supplies Expense	1,450	
	<u>\$263,350</u>	<u>\$263,350</u>

PA10. **L0 5.2** The following Post-Closing Trial Balance contains errors. Prepare a corrected Post-Closing Trial Balance:

Post-Closing Trial Balance		
	Debit	Credit
Cash	\$29,900	
Prepaid Insurance	5,500	
Fixed Assets		\$ 50,000
Notes Payable		46,000
Common Stock	32,000	
Retained Earnings		7,400
	<u>\$67,400</u>	<u>\$103,400</u>

PA11. **L0 5.2** Assuming the following Adjusted Trial Balance, recreate the Post-Closing Trial Balance that would result after all closing journal entries were made and posted:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$17,900	
Accounts Receivable	9,900	
Supplies	1,600	
Prepaid Insurance	2,500	
Salaries Payable		\$ 8,600
Common Stock		10,000
Retained Earnings		2,800
Dividends	4,000	
Service Fee Revenue		37,050
Salaries Expense	16,900	
Supplies Expense	4,200	
Insurance Expense	1,450	
	<u>\$58,450</u>	<u>\$58,450</u>

PA12. **L0 5.3** Use the following Adjusted Trial Balance to prepare a classified Balance Sheet:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$16,500	
Accounts Receivable	17,200	
Supplies	2,200	
Prepaid Insurance	2,100	
Equipment	14,000	
Accounts Payable		\$14,200
Unearned Fee Revenue		4,300
Common Stock		30,000
Service Fee Revenue		21,500
Salaries Expense	12,000	
Rent Expense	6,000	
	<u>\$70,000</u>	<u>\$70,000</u>

PA13. **L0** 5.3 Using the following Balance Sheet summary information, for the two years presented calculate:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Current assets	\$101,600	\$97,350
Current liabilities	33,650	32,800

PA14. **L0** 5.3 Using the following Balance Sheet summary information, calculate for the two companies presented:

- A. working capital
- B. current ratio

	Company N	Company O
Current assets	\$124,680	\$180,550
Current liabilities	63,250	153,250

PA15. **L0** 5.3 Using the following account balances, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Unearned revenue	\$12,600	\$ 6,000
Cash	33,200	12,750
Prepaid rent	9,000	6,000
Supplies	5,600	2,500
Taxes payable	4,800	5,500
Wages payable	8,500	9,250

PA16. **L0 5.4** From the following Company R adjusted trial balance, prepare the following:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet (simple—unclassified)
- D. Closing journal entries
- E. Post-Closing Trial Balance

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 44,000	
Accounts Receivable	13,800	
Prepaid Insurance	6,400	
Land	16,000	
Accounts Payable		\$ 14,900
Salaries Payable		4,500
Common Stock		31,000
Retained Earnings		10,200
Dividends	12,000	
Service Revenue		86,000
Insurance Expense	7,600	
Salaries Expense	32,000	
Miscellaneous Expense	14,800	
	<u>\$146,600</u>	<u>\$146,600</u>

PA17. **L0 5.4** From the following Company T adjusted trial balance, prepare the following:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet (simple—unclassified)
- D. Closing journal entries
- E. Post-Closing Trial Balance

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 24,000	
Accounts Receivable	14,900	
Prepaid Insurance	5,300	
Land	13,500	
Accounts Payable		\$ 12,400
Salaries Payable		1,500
Common Stock		34,000
Retained Earnings		10,200
Dividends	5,000	
Service Revenue		56,300
Insurance Expense	7,900	
Salaries Expense	39,000	
Miscellaneous Expense	4,800	
	<u>\$114,400</u>	<u>\$114,400</u>



Problem Set B

PB1. **LO 5.1** Identify whether each of the following accounts would be considered a permanent account (yes/no) and which financial statement it would be reported on (Balance Sheet, Income Statement, or Retained Earnings Statement).

- A. Common Stock
- B. Dividends
- C. Dividends Payable
- D. Equipment
- E. Income Tax Expense
- F. Income Tax Payable
- G. Service Revenue
- H. Unearned Service Revenue
- I. Net Income

PB2. **LO 5.1** The following selected accounts and normal balances existed at year-end. Make the four journal entries required to close the books:

Accounts receivable	\$33,200
Prepaid insurance	6,000
Land	48,000
Accounts payable	27,050
Notes payable	65,800
Retained earnings	9,350
Dividends	2,200
Fees earned revenue	70,500
Selling expenses	41,770
Administrative expenses	22,400
Miscellaneous expense	1,835

PB3. **LO 5.1** The following selected accounts and normal balances existed at year-end. Notice that *expenses exceed revenue* in this period. Make the four journal entries required to close the books:

Accounts receivable	\$ 85,500
Prepaid insurance	18,000
Land	15,000
Accounts payable	82,350
Notes payable	35,000
Retained earnings	129,650
Dividends	15,000
Fees earned revenue	311,000
Selling expenses	210,000
Administrative expenses	105,000
Miscellaneous expense	8,500

PB4. **L0 5.1** Use the following Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 75,500	
Accounts Receivable	15,500	
Accounts Payable		\$ 4,000
Unearned Revenue		6,000
Common Stock		20,000
Retained Earnings		12,500
Dividends	30,000	
Service Revenue		355,000
Advertising Expense	30,000	
Rent Expense	36,000	
Utilities Expense	9,500	
Wages Expense	201,000	
	<u>\$397,500</u>	<u>\$397,500</u>

PB5. **L0 5.1** Use the following Adjusted Trial Balance to prepare the four journal entries required to close the books:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 8,625	
Accounts Receivable	11,600	
Accounts Payable		\$ 8,450
Unearned Revenue		1,500
Common Stock		10,000
Retained Earnings		12,275
Dividends	2,000	
Service Revenue		97,500
Advertising Expense	2,500	
Rent Expense	18,000	
Utilities Expense	12,000	
Wages Expense	75,000	
	<u>\$129,725</u>	<u>\$129,725</u>

PB6. **L0** 5.1 Use the following T-accounts to prepare the four journal entries required to close the books:

Debit	Credit
Cash	
Bal. 17,340	
Rent Revenue	
	Bal. 240,000
Advertising Expense	
Bal. 12,000	
Insurance Expense	
Bal. 34,500	
Salaries Expense	
Bal. 128,000	
Dividends	
Bal. 22,000	
Retained Earnings	
	Bal. 59,500

PB7. **L0** 5.1 Assume that the first two closing entries have been made and posted. Use the T-accounts provided below to:

- complete the closing entries
- determine the ending balance in the Retained Earnings account

Debit	Credit
Income Summary	
148,500	162,200
Retained Earnings	
	Bal. 11,500
Dividends	
Bal. 4,000	

PB8. **LO 5.1** Correct any obvious errors in the following closing entries by providing the four corrected closing entries. Assume all accounts held normal account balances in the Adjusted Trial Balance.

A.

Income Summary	\$75,000	
Service Revenue		\$75,000

B.

Automobile Expense	\$ 8,800	
Insurance Expense	4,800	
Salaries Expense	45,000	
Supplies Expense	3,500	
Income Summary		\$62,100

C.

Retained Earnings	\$45,222	
Income Summary		\$45,222

D.

Dividends	\$6,000	
Retained Earnings		\$6,000

PB9. **LO 5.2** Assuming the following Adjusted Trial Balance, create the Post-Closing Trial Balance that would result after all closing journal entries were made and posted:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 8,625	
Accounts Receivable	11,600	
Accounts Payable		\$ 8,450
Unearned Revenue		1,500
Common Stock		10,000
Retained Earnings		12,275
Dividends	2,000	
Service Revenue		97,500
Advertising Expense	2,500	
Rent Expense	18,000	
Utilities Expense	12,000	
Wages Expense	75,000	
	<u>\$129,725</u>	<u>\$129,725</u>

PB10. **L0** 5.2 The following Post-Closing Trial Balance contains errors. Prepare a corrected Post-Closing Trial Balance:

Post-Closing Trial Balance		
	Debit	Credit
Cash		\$32,660
Supplies	\$ 7,200	
Land		25,000
Notes Payable	47,700	
Common Stock		7,000
Retained Earnings		10,160
	<u>\$54,900</u>	<u>\$74,820</u>

PB11. **L0** 5.2 Assuming the following Adjusted Trial Balance, re-create the Post-Closing Trial Balance that would result after all closing journal entries were made and posted:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 5,450	
Accounts Receivable	4,700	
Supplies	250	
Prepaid Insurance	1,250	
Salaries Payable		\$ 650
Common Stock		5,000
Retained Earnings		750
Dividends	1,400	
Service Fee Revenue		17,300
Salaries Expense	9,050	
Supplies Expense	1,000	
Insurance Expense	600	
	<u>\$23,700</u>	<u>\$23,700</u>

PB12. **L0** 5.3 Use the following Adjusted Trial Balance to prepare a classified Balance Sheet:

Adjusted Trial Balance		
	Debit	Credit
Cash	\$17,000	
Accounts Receivable	8,500	
Supplies	1,500	
Prepaid Insurance	5,000	
Equipment	12,000	
Accounts Payable		\$ 5,000
Unearned Fee Revenue		4,000
Common Stock		15,000
Service Fee Revenue		32,500
Salaries Expense	9,500	
Rent Expense	3,000	
	<u>\$56,500</u>	<u>\$56,500</u>

PB13. **L0** 5.3 Using the following Balance Sheet summary information, calculate for the two years presented:

- A. working capital
- B. current ratio

	Company P	Company Q
Current assets	\$88,500	\$39,000
Current liabilities	67,430	18,800

PB14. **L0** 5.3 Using the following Balance Sheet summary information, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Current assets	\$10,500	\$12,050
Current liabilities	7,500	10,800

PB15. **L0** 5.3 Using the following account balances, calculate for the two years presented:

- A. working capital
- B. current ratio

	12/31/2018	12/31/2019
Accounts payable	\$12,790	\$1,530
Accounts receivable	16,330	2,200
Cash	21,040	5,550
Prepaid insurance	4,500	1,200
Salaries payable	6,500	4,000
Utilities payable	1,200	550

PB16. **L0** 5.4 From the following Company S adjusted trial balance, prepare the following:

- A. Income Statement
- B. Retained Earnings Statement
- C. Balance Sheet (simple—unclassified)
- D. Closing journal entries
- E. Post-Closing Trial Balance

Adjusted Trial Balance		
	Debit	Credit
Cash	\$ 55,200	
Accounts Receivable	30,200	
Prepaid Insurance	6,000	
Land	30,000	
Accounts Payable		\$ 14,300
Salaries Payable		6,100
Common Stock		26,000
Retained Earnings		38,900
Dividends	16,500	
Service Revenue		211,850
Insurance Expense	24,000	
Salaries Expense	128,350	
Miscellaneous Expense	6,900	
	<u>\$297,150</u>	<u>\$297,150</u>



Thought Provokers

TP1. **L0 5.1** Assume you are the controller of a large corporation, and the chief executive officer (CEO) has requested that you refrain from posting closing entries at 20X1 year-end, with the intention of combining the two years' profits in year 20X2, in an effort to make that year's profits appear stronger.

Write a memo to the CEO, to offer your response to the request to skip the closing entries for year 20X1.

TP2. **L0 5.1** Search the Securities and Exchange Commission website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>) and locate the latest Form 10-K for a company you would like to analyze. Submit a short memo:

- State the name and ticker symbol of the company you have chosen.
- Review the company's end-of-period Balance Sheet, Income Statement, and Statement of Retained Earnings.
- Use the information in these financial statements to answer these questions:
 - A. If the company had used the income summary account for its closing entries, how much would the company have credited the Income Summary account in the first closing entry?
 - B. How much would the company have debited the Income Summary account in the second closing entry?

Provide the web link to the company's Form 10-K, to allow accurate verification of your answers.

TP3. **L0 5.1** Assume you are a senior accountant and have been assigned the responsibility for making the entries to close the books for the year. You have prepared the following four entries and presented them to your boss, the chief financial officer of the company, along with the company CEO, in the weekly staff meeting:

Service revenue	\$522,000	
Income summary		\$522,000
Income summary	463,520	
Promotional expenses		48,520
Salaries expense		375,500
Travel expenses		39,500
Income summary	58,480	
Retained earnings		58,480
Retained earnings	28,000	
Dividends		28,000

As the CEO was reviewing your work, he asked the question, "What do these entries mean? Can we learn anything about the company from reviewing them?"

Provide an explanation to give to the CEO about what the entries reveal about the company's operations this year.

TP4. **L0** **5.2** Search the US Securities and Exchange Commission website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>) and locate the latest Form 10-K for a company you would like to analyze.

Submit a short memo:

- State the name and ticker symbol of the company you have chosen.
- Review the company's Balance Sheets.
- Reconstruct a Post-Closing Trial Balance for the company from the information presented in the financial statements.

Provide the web link to the company's Form 10-K, to allow accurate verification of your answers.

TP5. **L0** **5.3** Search the Securities and Exchange Commission website (<https://www.sec.gov/edgar/searchedgar/companysearch.html>) and locate the latest Form 10-K for a company you would like to analyze.

Submit a short memo:

- State the name and ticker symbol of the company you have chosen.
- Review the company's end-of-period Balance Sheet for the most recent annual report.
- List the amount of Current Assets and Current Liabilities for the currently reported year, and for the previous year. Use these amounts to calculate the company's (A) working capital and (B) current ratio.

Provide the web link to the company's Form 10-K, to allow accurate verification of your answers.

