Fundamental Financial Accounting Concepts 10th edition Edmonds Solutions Manual

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Chapter 2

Accounting for Accruals and Deferrals

General Comments for Chapter 2

This chapter is divided into two sections. Section 1 covers accruals. Section 2 covers deferrals. We recommend that you cover each section as a separate chapter. Specifically, introduce accruals and work the related exercises and problems before moving to Section 2. Grasping the accrual accounting is challenging for many students. Depreciation and the treatment of interest are particularly difficult. Indeed, we recommend that you delay coverage of these subjects until Chapter 8 (Accounting for Long-Term Operational Assets) and Chapter 10 (Accounting for Long-Term Debt). The main body of Chapter 2 omits coverage of these topics. However, if your students are up to the challenge and you would like to include an introduction to depreciation and interest, these topics are covered in an appendix to the chapter. Also, there are exercises and problems in the end-of-chapter materials that include coverage of these topics. Accordingly, it is easy to either include or delay coverage of depreciation and interest within the confines of Chapter 2.

Some instructors choose to delay the introduction of the horizontal financial statements model until Chapter 2. If you have chosen this approach, you should return to Requirement D of Demonstration Problem 1-1 before beginning coverage of the accrual accounting concepts presented in this chapter. The horizontal financial statements model is used extensively throughout this text. Thorough coverage of the model should begin soon after students have a clear understanding of financial statements.

Chapter 1 assumed that all transactions were cash-based. This is a good starting point because most students enter introductory accounting with the assumption that all transactions involve cash. This notion must be dispelled before you introduce your students to accrual accounting. We suggest that you begin with a very simple scenario. The following problem-based-learn case provides a opportunity for students to confront the difference between cash-based versus accrual accounting. The case requires students to determine the amount of revenue to recognize when cash is collected in a different period than when the work is performed. It also requires students to determine the amount of expense to recognize when resources are used in one period but paid for in a different period. It offers the opportunity to introduce the terms accounts receivable and payable.

If you prefer you can use an even simpler scenario by limiting the case to events that relate only to revenue recognition. For example, display the following events on a chalk board or projection screen.

Event 1: Mary Jones provided $100 of tutoring services to a student in Year 1.
Event 2: The student paid Mary for her work in Year 2.

Based on this information alone, what should appear on Mary's Year 1 Balance Sheet and Income Statement? Further, what would appear on the Year 2 statements?

After discussing this simple scenario, move on to the more comprehensive problem-based-learning case.

Chapter 2 Problem-Based Learning Case: Accrual Accounting

(We describe problem-based learning in the introduction to this manual.)

Instructions: The case appears on the following page in a format you can copy or display. Distribute copies of the case to the class before explaining accrual accounting. Ask students to individually develop answers. After allowing students time to develop their individual answers, put them into groups to reach consensus on an answer. Also, ask each group to select a spokesperson. Allow groups time to develop answers, and then call on some of the spokespersons to share their solutions. As you respond to the student solutions, explain the basic concepts of accrual accounting with respect to revenues earned and expenses incurred on account.

The final result is:

Net income: revenue of $145,000 less expenses of $80,000 = $65,000.
Total assets: cash, $45,000 plus accounts receivable, $25,000 = $70,000.
Total liabilities: salaries payable: $5,000.

Chapter 2 Problem-Based Learning Case: Accrual Accounting

Professional Headhunters, Inc. (PHI), a job placement company, operates in the northeastern United States. During Year 1, the company earned $145,000 in revenue by providing services to customers. However, it collected only $120,000 of the revenue in cash. PHI expected to collect the remaining $25,000 in Year 2. In addition, PHI incurred $80,000 of expenses. However, by the end of Year 1, PHI had paid only $75,000 of the cash owed for expenses because it had not yet paid $5,000 to employees who had worked during Year 1 but had not been paid by the end of the year. PHI expected to pay the $5,000 in cash to the employees during Year 2. Based on this information alone, determine the amount of net income, total assets, and total liabilities PHI should report on its Year 1 financial statements.

Detailed Lesson Plan for Chapter 2 – Section 1

I. **Distribute copies of Demonstration Problem 2-1.** You may skip some of the steps described below if you have used the problem-based-learning case as described above. Alternatively, you may use Demonstration Problem 2-1 as a reinforcement exercise.

A. Explain the phrase "***on account.***" Tell students this means Packard recognizes the revenue when it is earned, which may be before it collects the cash. Packard's customers created charge accounts and purchased goods or services by charging the purchases to their accounts. Revenue is recognized in the accounting period in which the services are provided regardless of when cash changes hands. This discussion should lead to defining the term accrual. In general, transactions in which a revenue or expense is recognized before cash changes hands are called ***accruals***. Demonstrate this point by recording the revenue recognition for Packard using the horizontal financial statements model. Next, have your students prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. To minimize the time required to prepare these financial statements, you may provide students with copies of the workpaper for Demonstration Problem 2-1. The workpaper is near the back of this chapter of the Instructor's Manual.

B. Since Packard did not issue any stock, the statement of changes in stockholders' equity becomes a statement of retained earnings. Although the text does not cover a statement of retained earnings, students should be able to infer the format from their experience with the statement of changes in stockholders' equity. Use the exercise to discuss diversity in reporting practice. Although there is general consistency in financial reporting, there is also variety. Students should learn to understand different reporting formats.

C. After accounting for the Year 1 revenue, assume Packard collects the $5,000 account receivable in Year 2. This is the only Year 2 transaction. Have students record the event using the horizontal financial statements model and prepare the four basic financial statements for the Year 2 accounting period. Encourage students to analyze the difference between the amount of net income and the amount of cash flow from operating activities. This single transaction clearly illustrates differences between the income statement and the statement of cash flows.

II. **Use Exercises 2-3A&B from the text to reinforce events associated with receivables and payables.** Exercises 2-3A&B provide a comprehensive overview of receivables and payables occurring through a complete accounting cycle. The exercises require students to recorded events under an accounting equation and to prepare a complete set financial statements.

III. Use Exercises 2-4A&B from the text to show students how receivables and payables are recorded in a horizontal financial statements model. The horizontal financial statements model is particularly useful in showing how accruals affect the financial statements. Begin by recording a simple revenue earned on account transaction in a statements model as shown below. Use the model to highlight the difference between net income and cash flow from operating activities.

	Balance Sheet							Income Statement					Statement of Cash Flow
Year	Cash	+	Acct. Rec.	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	
1	n/a	+	5,000	=	n/a	+	5,000	5,000	−	n/a	=	5,000	n/a

After this brief introduction, have students complete Exercise 2-4B in class and assign 2-4A as a homework assignment.

Detailed Lesson Plan for Chapter 2 – Section 2

IV. Use Demonstration Problem 2-2 to introduce the deferral concept. Define the term ***unearned revenue***. Explain that ***unearned revenue is a liability*** because it represents an ***obligation to provide future services***. Make the point that businesses can be ***obligated*** to provide services as well as to pay cash. Show your students how to record the liability using the horizontal financial statements model. Record the Year 1 events under an accounting equation (Requirement a). There are two Year 1 events including the (1) collection of the retainer and (2) year-end adjustment to recognize revenue. Next have the students record the Year 2 events under an accounting equation (Requirement b). Finally, have the students prepare a formal set of financial statements (Requirement c). If time permits, immediately after students have had time to complete Requirement a, organize them into pairs and have them share their solutions with each other. Circulate among the students observing their work and answering questions. Then show and discuss the solution to Requirement a before moving on to Requirement b. It is important to keep you and your students actively involved in the learning process. Break up the class with brief lectures followed by short in-class work sessions. Long lecture monologues lead to boredom and disinterest. Always seek to keep your students actively involved in the learning process.

A. When you explain the year-end adjustment necessary to recognize three months of earned revenue on December 31, Year 1 emphasize the difference between the amount of cash collected and the amount of revenue recognized. Highlight that Jackson earned and recognized the revenue *after* it collected the cash. Draw a general definition of deferrals from this illustration. ***Transactions in which a revenue or expense is recognized after cash changes hands are termed deferrals.*** Contrast deferrals with accruals which were presented in Demonstration Problem 2-1. For emphasis, reiterate the explanation of an accrual. ***Transactions in which a revenue or expense is recognized before cash changes hands are termed accruals.*** Although these are not precise definitions, they describe the basic concepts in terms students can understand. Explain that accrual accounting uses both accruals and deferrals.

B. Also note the connection between reducing the liability account (unearned revenue) and recognizing revenue, reinforcing that ***revenue is an increase in assets or a decrease in liabilities from providing services or products to customers***. Similarly, an ***expense is a decrease in assets or an increase in liabilities that occurs in efforts to produce revenue***. ***Net income is a change in wealth*** (increase in net assets). It is not enough to orally define terms. You must repeatedly demonstrate the definitions within the context of problems. Gradually, students will understand fundamental accounting interrelationships.

V. **Use separate examples to introduce other types of deferrals (prepaid assets and supplies).** You can use exercises 2-8, 2-9, or 2-11 in the textbook as demonstration problems, or create your own. We often create problem-based exercises like these spontaneously in the classroom. For example, instead of defining prepaid assets, simply give the students an event involving a prepaid asset. Say, "On October 1, Year 1, ABC Company paid $1,200 in advance for one year of property insurance protection." Without having ever discussed prepaid insurance, ask the students to record the event using the horizontal financial statements model. Make them write down an answer. Don't be concerned with accuracy. Be concerned with involvement. Walk around the room and look at what they are doing. Occasionally collect these exercises from the students as in-class assignments. Give them credit regardless of their answers. The grade is for participation, not accuracy. Your objective is to motivate them to think about the problem before you offer a solution. At this stage, you are not evaluating their performance.

VI. **Time considerations and homework assignments.** Completing Demonstration Problems 2-1A & B should require approximately one hour of class time. Have the students work along with you as you explain the problems. Exercises 2-3, 2-15, 2-16, and 2-17 parallel the Demonstration Problems and can be considered for homework assignments.

VII. **Use Demonstration Problem 2-3 as a comprehensive summary problem.** This is a two-cycle problem. Explain the first cycle (Year 1) and then use the second cycle as an in-class assignment. Allot approximately one hour to complete this assignment. Students needing additional time can finish the problem as homework. Problem 2-38 mirrors the demonstration problem and can be used as a homework assignment.

VII. **Appendix**

A. Use Exercises 2-35A&B to demonstrate accounting for accrued interest.
B. Use Exercises 2-34A&B to demonstrate accounting for depreciation.
C. Use **Demonstration Problem 2-4** for a comprehensive multi-cycle problem that includes accrued interest and depreciation.

Demonstration Problems for Chapter 2

Demonstration Problem 2-1: Revenue Earned on Account

Year 1
Packard Consultants was started in Year 1. During that year, the company earned $5,000 of consulting revenue ***on account***. Assume this is the only event experienced by Packard during Year 1. During Year 2, Packard Consultants collected $4,000 cash from the account receivable it established in Year 1.

Required
a. Record the Year 1 event under an accounting equation.
b. Record the Year 2 event under an accounting equation.
c. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1 and Year 2.

Demonstration Problem 2-2: Unearned Revenue

Jackson Legal Services was started when a client paid the firm a $12,000 cash retainer on October 1, Year 1. Jackson agreed to provide legal advice to the client for a one-year period beginning on the date of the cash receipt. The closing date for the law practice is December 31.

Required
a. Record the Year 1 events under an accounting equation.
b. Record the Year 2 events under an accounting equation.
c. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1 and Year 2.

Demonstration Problem 2-3: Accruals and Deferrals

Smith Company experienced the following accounting events during Year 1:

1. Smith Company was started on January 1 when it issued common stock for $2,000 cash.
2. During the year, the company recognized $1,500 of consulting revenue on account.
3. The company collected $1,200 cash from accounts receivable.
4. Smith accrued salary expense during the year of $900.
5. Paid $700 of the salaries payable liability.
6. Paid dividends of $100 to the stockholders.
7. Paid $360 cash for an insurance policy that covered the company for one year beginning March 1, Year 1.
8. On November 1, Year 1, Smith collected $2,880 cash in advance for consulting services to be provided under a one-year contract.
9. Recognized insurance expense (Policy in event 7) for ten months.
10. Recognized income earned under the one-year contract at December 31, Year 1.

Smith Company experienced the following accounting events during Year 2:

11. Smith Company issued additional common stock for $3,000 cash.
12. During the period, Smith recognized $2,700 of consulting revenue earned on account.
13. Smith collected $2,800 cash from accounts receivable.
14. Smith accrued salary expense of $1,500.
15. The company paid $1,350 of the salaries payable liability.
16. Smith paid dividends of $300 to the stockholders.
17. Paid $420 cash to renew the insurance policy for another one-year term.
18. Smith adjusted the books to reflect the insurance expense that had been incurred in Year 2 (described in event 7 of Year 1).
19. Smith adjusted the books to reflect the revenue earned in Year 2 under the one-year consulting contract that began in Year 1 (event 8 in Year 1).

Required

a. Record the events using the horizontal financial statements model.
b. For Year 1 and Year 2, prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows.

Demonstration Problem 2-4: Appendix: Interest and Depreciation

Bill Sanders started a part-time consulting practice, Sanders Consulting Associates (SCA), on January 1, Year 1. SCA experienced the following transactions during Year 1.

1. Acquired $3,000 cash from issuing common stock.
2. Purchased a $2,000 computer system.
3. Paid $100 cash for supplies.
4. Paid $360 cash for an insurance policy that covered the company for one year beginning March 1, Year 1.
5. Recognized $2,800 of consulting revenue for services provided on account.
6. Collected $2,200 of the receivables due from customers.
7. Recognized $1,750 of accrued operating expenses (not related to supplies or insurance) that were charged to accounts payable.
8. Paid suppliers $900 of the amount owed on the accounts payable.
9. On November 1, Year 1, Sanders collected $2,880 cash in advance for services to be provided under a one-year contract.
10. Paid dividends of $200 to the stockholders.
11. Purchased land for $2,460 cash.

Year 1 Adjustments

12. Recognized depreciation expense. The computer was purchased on January 1, Year 4. It had a three-year useful life and a $200 salvage value.
13. Recognized supplies expense. Based on a physical count, there were $20 of supplies on hand at the close of business on December 31, Year 1.
14. Recognized insurance expense for ten months.
15. Recognized income earned on the service contract described in Event No. 9.

SCA experienced the following transactions during Year 2:

1. Acquired additional common stock for $1,000 cash.
2. Sold the land that it owned for $2,460 cash.
3. Paid cash to purchase $125 of supplies.
4. Borrowed $3,000 cash from a local bank.
5. Paid $420 cash to renew the insurance policy for another one-year term.
6. Recognized revenue of $4,700 for services provided on account.
7. Collected $4,200 of the receivables due from customers.
8. Recognized accrued operating expenses (not related to supplies or insurance) of $3,300. These operating expenses were charged to accounts payable.
9. Paid suppliers $2,900 of the amount owed on the accounts payable.
10. Paid dividends of $1,800 cash to the stockholders.

Year 2 Adjustments

11. Recognized revenue earned when remaining services were performed under the service contract. (See Event No. 9 in Year 1.)
12. Recognized depreciation expense on the computer for the year.
13. Recognized supplies expense. There were $35 of supplies on hand at the close of business on December 31, Year 2.
14. Recognized insurance expense for twelve months. Recall that the beginning balance in the prepaid insurance account represents two months' insurance that was purchased in Year 1. Rates in Year 2 were higher than those in Year 1. The policy was renewed on March 1, Year 2 for a $420 annual premium.
15. Recognized the accrued interest on the note payable issued in Event No. 4. The bank note had a 12 percent annual interest rate and a one-year term. Assume that the funds were borrowed on December 1, Year 2.

Required

a. Record the events for Year 1 and Year 2 in ledger account balances under an accounting equation.

b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1 and Year 2.

c. Use a horizontal financial statements model to show how the events for Year 1 and Year 2 affect financial statements. Use a plus sign to indicate an increase, a minus sign to indicate a decrease, and the initials NA to indicate not affected. In the statement of cash flows column use, a plus sign to indicate a cash inflow, a minus sign to indicate a cash outflow. Also, use OA to indicate operating activities, IA to indicate investing activities, and FA to indicate financing activities.

Solutions for Chapter 2 Demonstration Problems

Demonstration Problem 2-1: Requirements a and b

	Assets			=	Liabilities	+	Stk. Equity		
Year 1	**Cash**	**+**	**Accounts Receivable**	**=**	**Liabilities**	**+**	**Common Stock**	**+**	**Retained Earnings**
Beginning balances	**0**		**0**		**0**		**0**		**0**
Effect of recognizing revenue			**5,000**						**5,000**
Year 2									
Effect of collecting cash	**4,000**		**(4,000)**						
Ending balances	**4,000**	**+**	**1,000**	**=**	**0**	**+**	**0**	**+**	**5,000**

Demonstration Problem 2-1: Requirement c

Packard Consultants		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Consulting revenue	$5,000	$ 0
Expenses	0	0
Net income	$5,000	$ 0
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$5,000
Plus: Net income	5,000	0
Less: Dividends	0	0
Ending retained earnings	$5,000	$5,000
Balance Sheets at December 31		
Assets		
Cash	$ 0	$4,000
Accounts receivable	5,000	1,000
Total assets	$5,000	$5,000
Equity		
Retained earnings	$5,000	$5,000
Statements of Cash Flows		
Cash flows from operating activities	$ 0	$4,000
Cash flows from investing activities	0	0
Cash flows from financing activities	0	0
Net change in cash	0	4,000
Beginning cash balance	0	0
Ending cash balance	$ 0	$4,000

Demonstration Problem 2-2: Requirements a and b

	Assets	=	Liabilities	+	Equity		
Year 1	**Cash**	**=**	**Unearned Revenue**	**+**	**Com. Stock**	**+**	**Ret. Earn.**
Beginning balances	$ 0		$ 0		$ 0		$ 0
1. Recognize liability	12,000		12,000				
2. Adjustment for earned revenue			(3,000)				3,000
Ending/beginning balances	$12,000	=	$ 9,000	+	$ 0	+	$3,000
Year 2							
1. Adjustment for earned revenue			(9,000)				9,000
Ending balances	$12,000		$ 0		$ 0		$12,000

Demonstration Problem 2-2: Requirement c

Jackson Legal Services Financial Statements		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Fees revenue	$ 3,000	$ 9,000
Expenses	0	0
Net income	$ 3,000	$ 9,000
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$ 3,000
Plus: Net income	3,000	9,000
Less: Dividends	0	0
Ending retained earnings	$ 3,000	$12,000
Balance Sheets as of December 31		
Assets		
Cash	$12,000	$12,000
Liabilities		
Unearned revenue	$ 9,000	$ 0
Equity		
Retained earnings	3,000	12,000
Total liabilities and equity	$12,000	$12,000
Statements of Cash Flows		
Cash flows from operating activities	$12,000	$ 0
Cash flows from investing activities	0	0
Cash flows from financing activities	0	0
Net change in cash	12,000	0
Beginning cash balance	0	12,000
Ending cash balance	$12,000	$12,000

Demonstration Problem 2-3: Requirement a

	Balance Sheet														Income Statement					Statement of Cash Flows
	Assets						Liabilities				Stk. Equity									
Year 1	Cash	+	Acct. Rec.	+	Prepaid Rent	=	Sal. Pay.	+	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.		Rev.	–	Exp.	=	Net Inc.	
Beg. Bal.	0	+	0	+	0	=	0	+	0	+	0	+	0		0	–	0	=	0	NA
1	2,000	+	NA	+	NA	=	NA	+	NA	+	2,000	+	NA		NA	–	NA	=	NA	2,000 FA
2	NA	+	1,500	+	NA	=	NA	+	NA	+	NA	+	1,500		1,500	–	NA	=	1,500	NA
3	1,200	+	(1,200)	+	NA	=	NA	+	NA	+	NA	+	NA		NA	–	NA	=	NA	1,200 OA
4	NA	+	NA	+	NA	=	900	+	NA	+	NA	+	(900)		NA	–	900	=	(900)	NA
5	(700)	+	NA	+	NA	=	(700)	+	NA	+	NA	+	NA		NA	–	NA	=	NA	(700) OA
6	(100)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(100)		NA	–	NA	=	NA	(100) FA
7	(360)	+	NA	+	360	=	NA	+	NA	+	NA	+	NA		NA	–	NA	=	NA	(360) OA
8	2,880	+	NA	+	NA	=	NA	+	2,880	+	NA	+	NA		NA	–	NA	=	NA	2,880 OA
9	NA	+	NA	+	(300)	=	NA	+	NA	+	NA	+	(300)		NA	–	300	=	(300)	NA
10	NA	+	NA	+	NA	=	NA	+	(480)	+	NA	+	480		480	–	NA	=	480	NA
End. Bal.	4,920	+	300	+	60	=	200	+	2,400	+	2,000	+	680		1,980	–	1,200	=	780	4,920 NC
Year 2																				
Beg. Bal.	4,920	+	300	+	60	=	200	+	2,400	+	2,000	+	680		NA	–	NA	=	NA	NA
11	3,000	+	NA	+	NA	=	NA	+	NA	+	3,000	+	NA		NA	–	NA	=	NA	3,000 FA
12	NA	+	2,700	+	NA	=	NA	+	NA	+	NA	+	2,700		2,700	–	NA	=	2,700	NA
13	2,800	+	(2,800)	+	NA	=	NA	+	NA	+	NA	+	NA		NA	–	NA	=	NA	2,800 OA
14	NA	+	NA	+	NA	=	1,500	+	NA	+	NA	+	(1,500)		NA	–	1,500	=	(1,500)	NA
15	(1,350)	+	NA	+	NA	=	(1,350)	+	NA	+	NA	+	NA		NA	–	NA	=	NA	(1,350) OA
16	(300)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(300)		NA	–	NA	=	NA	(300) FA
17	(420)	+	NA	+	420	=	NA	+	NA	+	NA	+	NA		NA	–	NA	=	NA	(420) OA
18	NA	+	NA	+	(410)	=	NA	+	NA	+	NA	+	(410)		NA	–	410	=	(410)	NA
19	NA	+	NA	+	NA	=	NA	+	(2,400)	+	NA	+	2,400		2,400	–	NA	=	2,400	NA
End Bal.	8,650	+	200	+	70	=	350	+	0	+	5,000	+	3,570		5,100	–	1,910	=	3,190	3,730 NC

Demonstration Problem 2-3: Requirement b

Income Statements for the Years Ended 12/31	Year 1	Year 2
Consulting revenue	$ 1,980	$ 5,100
Total revenue	1,980	5,100
Salary expense	(900)	(1,500)
Insurance Expense	(300)	(410)
Net income	780	$ 3,190
Statements of Changes in Stockholders' Equity		
Beginning common stock	$ 0	$ 2,000
Plus: Common stock issued	2,000	3,000
Ending common stock	2,000	5,000
Beginning retained earnings	0	680
Plus: Net income	780	3,190
Less: Dividends	(100)	(300)
Ending retained earnings	680	3,570
Total stockholders' equity	$ 2,680	$ 8,570
Balance Sheets as of December 31		
Cash	$ 4,920	$ 8,650
Accounts receivable	300	200
Prepaid Insurance	60	70
Total assets	$ 5,280	$ 8,920
Salaries payable	$ 200	$ 350
Unearned Revenue	2,400	0
Total liabilities	2,600	350
Common stock	2,000	5,000
Retained earnings	680	3,570
Total stockholders' equity	2,680	8,570
Total liabilities and stockholders' equity	$ 5,280	$ 8,920
Statements of Cash Flows		
Cash flows from operating activities		
Cash receipts from consulting revenue	$ 4,080	$ 2,800
Cash payments for salaries	(700)	(1,350)
Cash payments for insurance	(360)	(420)
Net cash inflow from operating activities	3,020	1,030
Cash flows from investing activities		
Net cash outflow for investing activities	0	0
Cash flows from financing activities		
Cash receipt from common stock issue	2,000	3,000
Cash payment for dividends	(100)	(300)
Net cash inflow from financing activities	1,900	2,700
Net change in cash	4,920	3,730
Beginning cash balance	0	4,920
Ending cash balance	$ 4,920	$ 8,650

Demonstration Problem 2-4: Requirement a

Year 1 Ledger Account Balances Prior to Closing

Assets = Liabilities + Equity

Assets

Cash

(1)	3,000
(2)	(2,000)
(3)	(100)
(4)	(360)
(6)	2,200
(8)	(900)
(9)	2,880
(10)	(200)
(11)	(2,460)
Bal.	2,060

Accts. Rec.

(5)	2,800
(6)	(2,200)
Bal.	600

Supplies

(3)	100
(13)	(80)
Bal.	20

Prepaid Ins.

(4)	360
(14)	(300)
Bal.	60

Comp. Equip.

(2)	2,000

Accum. Dep.

(12)	(600)

Land

(11)	2,460

Liabilities

Unearned Rev.

(9)	2,880
(15)	(480)
Bal.	2,400

Accts. Pay.

(7)	1,750
(8)	(900)
Bal.	850

Equity

Com. Stock

(1)	$3,000

Ret. Earn.

(5)	$2,800	Consult. Rev.
(7)	(1,750)	Oper. Exp.
(10)	(200)	Dividends
(12)	(600)	Dep. Exp.
(13)	(80)	Supplies Exp.
(14)	(300)	Insurance Exp.
(15)	480	Consult. Rev.
Bal.	350	

Total Assets	=	Total Liab.	+	Total Stockholders' Equity
6,600	=	3,250	+	3,350

Demonstration Problem 2-4: Requirement a

Year 2 Ledger Account Balances Prior to Closing

Assets = Liabilities + Equity

Assets

Cash	
Bal.	2,060
(1)	1,000
(2)	2,460
(3)	(125)
(4)	3,000
(5)	(420)
(7)	4,200
(9)	(2,900)
(10)	(1,800)
Bal.	7,475

Accts. Rec.	
Bal.	600
(6)	4,700
(7)	(4,200)
Bal.	1,100

Supplies	
Bal.	20
(3)	125
(13)	(110)
Bal.	35

Prepaid Ins.	
Bal.	60
(5)	420
(14)	(410)
Bal.	70

Comp. Equip.	
Bal.	2,000

Accum. Dep.	
Bal.	(600)
(12)	(600)
Bal.	(1,200)

Land	
Bal.	2,460
(2)	(2,460)
Bal.	-0-

Liabilities

Unearned Rev.	
Bal.	2,400
(11)	(2,400)
Bal.	-0-

Accts. Pay.	
Bal.	850
(8)	3,300
(9)	(2,900)
Bal.	1,250

Note Pay.	
(4)	3,000

Interest Pay.	
(15)	30

Equity

Com. Stock	
Bal.	3,000
(1)	1,000
Bal.	4,000

Ret. Earn		
Bal.	350	
(6)	4,700	Consult. Rev.
(8)	(3,300)	Oper. Exp
(10)	(1,800)	Dividends
(11)	2,400	Consult. Rev.
(12)	(600)	Dep. Exp.
(13)	(110)	Supplies Exp.
(14)	(410)	Ins. Exp.
(15)	(30)	Interest Exp.
Bal.	1,200	

Total Assets	=	Total Liab.	+	Total Stockholders' Equity
9,480	=	4,280	+	5,200

Demonstration Problem 2-4: Requirement b

Income Statements for the Year	Year 1	Year 2
Consulting Revenue	$3,280	$7,100
Total Expenses	(2,730)	(4,450)
Net Income	$ 550	$2,650
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$3,000
Plus: Common Stock Issued	3,000	1,000
Ending Common Stock	$3,000	$4,000
Beginning Retained Earnings	$ -0-	$ 350
Plus: Net Income	550	2,650
Less: Dividends	(200)	(1,800)
Ending Retained Earnings	$ 350	$1,200
Total Stockholders' Equity	$3,350	$5,200
Balance Sheets		
Assets		
Cash	$2,060	$7,475
Accounts Receivable	600	1,100
Supplies	20	35
Prepaid Insurance	60	70
Computer Equipment	2,000	2,000
Accumulated Depreciation	(600)	(1,200)
Land	2,460	-0-
Total Assets	$6,600	$9,480
Liabilities		
Unearned Revenue	$2,400	$ -0-
Accounts Payable	850	1,250
Interest Payable	-0-	30
Note Payable	-0-	3,000
Total Liabilities	$3,250	$4,280
Stockholders' Equity		
Common Stock	$3,000	$4,000
Retained Earnings	350	1,200
Total Stockholders' Equity	$3,350	$5,200
Total Liabilities and Stockholders' Equity	$6,600	$9,480

Demonstration Problem 2-4: Requirement b (continued)

Statements of Cash Flows	Year 1	Year 2
Cash Flows from Operating Activities		
Cash Receipts from Consulting Revenue	$ 5,080	$4,200
Cash Payments for Expenses	1,360	(3,445)
Net Cash Inflow from Operating Activities	$ 3,720	$ 755
Cash Flows from Investing Activities		
Cash Payment to Purchase Land	$(2,460)	$ -0-
Cash Payment to Purchase Computer Equipment	(2,000)	-0-
Cash Receipt from Sale of Land	-0-	2,460
Net Cash Inflow (Outflow) from Investing Activities	$(4,460)	$2,460
Cash Flows from Financing Activities		
Cash Receipt from Bank Loan	$ -0-	$3,000
Cash Receipt from Issuing Common Stock	3,000	1,000
Cash Payment for Dividends	(200)	(1,800)
Net Cash Inflow from Financing Activities	$2,800	$2,200
Net Change in Cash	$2,060	$5,415
Beginning Cash Balance	-0-	2,060
Ending Cash Balance	$2,060	$7,475

Demonstration Problem 2-4: Requirement c
Year 1

Event No.	Balance Sheet			Income Statement			Statement of Cash Flow
	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	
1	+	NA	+	NA	NA	NA	+ FA
2	− +	NA	NA	NA	NA	NA	− IA
3	− +	NA	NA	NA	NA	NA	− OA
4	− +	NA	NA	NA	NA	NA	− OA
5	+	NA	+	+	NA	+	NA
6	+ −	NA	NA	NA	NA	NA	+ OA
7	NA	+	−	NA	+	−	NA
8	−	−	NA	NA	NA	NA	− OA
9	+	+	NA	NA	NA	NA	+ OA
10	−	NA	−	NA	NA	NA	− FA
11	− +	NA	NA	NA	NA	NA	− IA
12	−	NA	−	NA	+	−	NA
13	−	NA	−	NA	+	−	NA
14	−	NA	−	NA	+	−	NA
15	NA	−	+	+	NA	+	NA

Demonstration Problem 2-4: Requirement c
Year 2

Event No.	Balance Sheet			Income Statement			Statement of Cash Flow
	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	
1	+	NA	+	NA	NA	NA	+ FA
2	+ −	NA	NA	NA	NA	NA	+ IA
3	− +	NA	NA	NA	NA	NA	− OA
4	+	+	NA	NA	NA	NA	+ FA
5	− +	NA	NA	NA	NA	NA	− OA
6	+	NA	+	+	NA	+	NA
7	+ −	NA	NA	NA	NA	NA	+ OA
8	NA	+	−	NA	+	−	NA
9	−	−	NA	NA	NA	NA	− OA
10	−	NA	−	NA	NA	NA	− FA
11	NA	−	+	+	NA	+	NA
12	−	NA	−	NA	+	−	NA
13	−	NA	−	NA	+	−	NA
14	−	NA	−	NA	+	−	NA
15	NA	+	−	NA	+	−	NA

Workpapers for Chapter 2 Demonstration Problems

Demonstration Problem 2-1: Requirements a and b

	Assets			=	Liabilities	+	Stk. Equity		
Year 1	Cash	+	Accounts Receivable	=	Liabilities	+	Common Stock	+	Retained Earnings
Beginning balances									
Effect of recognizing revenue									
Year 2									
Effect of collecting cash									
Ending balances	4,000	+	1,000	=	0	+	0	+	5,000

Demonstration Problem 2-1: Requirement c

Packard Consultants		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Consulting revenue		
Expenses		
Net income	$5,000	$ 0
Statements of Retained Earnings		
Beginning retained earnings		
Plus: Net income		
Less: Dividends		
Ending retained earnings	$5,000	$5,000
Balance Sheets at December 31		
Assets		
Cash		
Accounts receivable		
Total assets	$5,000	$5,000
Equity		
Retained earnings		
Statements of Cash Flows		
Cash flows from operating activities		
Cash flows from investing activities		
Cash flows from financing activities		
Net change in cash		
Beginning cash balance		
Ending cash balance	$ 0	$4,000

Demonstration Problem 2-2: Requirements a and b

	Assets	=	Liabilities	+	Equity		
Year 1	**Cash**	=	**Unearned Revenue**	+	**Com. Stock**	+	**Ret. Earn.**
Beginning balances							
1. Recognize liability							
2. Adjustment for earned revenue							
Ending/beginning balances	**$12,000**	=	**$ 9,000**	+	**$ 0**	+	**$3,000**
Year 2							
1. Adjustment for earned revenue							
Ending balances							

Demonstration Problem 2-2: Requirement c

Jackson Legal Services Financial Statements		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Fees revenue		
Expenses		
Net income		
Statements of Retained Earnings		
Beginning retained earnings		
Plus: Net income		
Less: Dividends		
Ending retained earnings	$ 3,000	$12,000
Balance Sheets as of December 31		
Assets		
Cash		
Liabilities		
Unearned revenue		
Equity		
Retained earnings		
Total liabilities and equity	$12,000	$12,000
Statements of Cash Flows		
Cash flows from operating activities		
Cash flows from investing activities		
Cash flows from financing activities		
Net change in cash		
Beginning cash balance		
Ending cash balance	$12,000	$12,000

Demonstration Problem 2-3: Requirement a

	Balance Sheet													Income Statement					Statement of Cash Flows
	Assets						Liabilities				Stk. Equity								
Year 1	Cash	+	Acct. Rec.	+	Prepaid Rent	=	Sal. Pay.	+	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	
Beg. Bal.	0	+	0	+	0	=	0	+	0	+	0	+	0	0	–	0	=	0	NA
1	2,000	+	NA	+	NA	=	NA	+	NA	+	2,000	+	NA	NA	–	NA	=	NA	2,000 FA
2																			
3																			
4																			
5																			
6																			
7																			
8																			
9																			
10																			
End. Bal.	4,920	+	300	+	60	=	200	+	2,400	+	2,000	+	680	1,980	–	1,200	=	780	4,920 NC
Year 2																			
Beg. Bal.																			
11																			
12																			
13																			
14																			
15																			
16																			
17																			
18																			
19																			
End Bal.	8,650	+	200	+	70	=	350	+	0	+	5,000	+	3,570	5,100	–	1,910	=	3,190	3,730 NC

Demonstration Problem 2-3: Requirement b

Income Statements for the Years Ended 12/31	Year 1	Year 2
Consulting revenue		
Total revenue		
Salary expense		
Insurance Expense		
Net income	780	$ 3,190
Statements of Changes in Stockholders' Equity		
Beginning common stock		
Plus: Common stock issued		
Ending common stock		
Beginning retained earnings		
Plus: Net income		
Less: Dividends		
Ending retained earnings		
Total stockholders' equity	$ 2,680	$ 8,570
Balance Sheets as of December 31		
Cash		
Accounts receivable		
Prepaid Insurance		
Total assets	$ 5,280	$ 8,920
Salaries payable		
Unearned Revenue		
Total liabilities		
Common stock		
Retained earnings		
Total stockholders' equity		
Total liabilities and stockholders' equity	$ 5,280	$ 8,920
Statements of Cash Flows		
Cash flows from operating activities		
Cash receipts from consulting revenue	$ 4,080	$ 2,800
Cash payments for salaries		
Cash payments for insurance		
Net cash inflow from operating activities		
Cash flows from investing activities		
Net cash outflow for investing activities		
Cash flows from financing activities		
Cash receipt from common stock issue		
Cash payment for dividends		
Net cash inflow from financing activities		
Net change in cash		
Beginning cash balance		
Ending cash balance	$ 4,920	$ 8,650

Demonstration Problem 2-4: Requirement a

Year 1 Ledger Account Balances Prior to Closing

Assets

Cash	
(1)	3,000
(11)	(2,460)
Bal.	2,060

Accts. Rec.	
Bal.	600

Supplies	

Prepaid Ins.	
Bal.	60

Comp. Equip.	
(2)	2,000

Accum. Dep.	

Land	

=

Liabilities

Unearned Rev.	
Bal.	2,400

Accts. Pay.	
Bal.	850

+

Equity

Com. Stock	
(1)	$3,000

Ret. Earn.	
(5)	$2,800
Bal.	350

Consult. Rev.	

Total Assets	=	Total Liab.	+	Total Stockholders' Equity
6,600	=	3,250	+	3,350

Demonstration Problem 2-4: Requirement a

Year 2 Ledger Account Balances Prior to Closing

Assets	=	Liabilities	+	Equity

Cash

Bal.	2,060
(1)	1,000
Bal.	7,475

Accts. Rec.

Bal.	1,100

Supplies

Bal.	35

Prepaid Ins.

Bal.	70

Comp. Equip.

Bal.	2,000

Accum. Dep.

Bal.	(1,200)

Land

Bal.	-0-

Unearned Rev.

Bal.	2,400
(11)	(2,400)
Bal.	-0-

Accts. Pay.

Bal.	1,250

Note Pay.

(4)	3,000

Interest Pay.

(15)	30

Com. Stock

Bal.	4,000

Ret. Earn

Bal.	350
(6)	4,700
Bal.	1,200

Total Assets	=	Total Liab.	+	Total Stockholders' Equity
9,480	=	4,280	+	5,200

Demonstration Problem 2-4: Requirement b

Income Statements for the Year	Year 1	Year 2
Consulting Revenue		
Total Expenses		
Net Income	$ 550	$2,650
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$3,000
Plus: Common Stock Issued		
Ending Common Stock		
Beginning Retained Earnings		
Plus: Net Income		
Less: Dividends		
Ending Retained Earnings		
Total Stockholders' Equity	$3,350	$5,200
Balance Sheets		
Assets		
Cash	$2,060	$7,475
Accounts Receivable		
Supplies		
Prepaid Insurance		
Computer Equipment		
Accumulated Depreciation		
Land		
Total Assets	$6,600	$9,480
Liabilities		
Unearned Revenue		
Accounts Payable		
Interest Payable		
Note Payable		
Total Liabilities	$3,250	$4,280
Stockholders' Equity		
Common Stock		
Retained Earnings		
Total Stockholders' Equity		
Total Liabilities and Stockholders' Equity	$6,600	$9,480

Demonstration Problem 2-4: Requirement b (continued)

Statements of Cash Flows	Year 1	Year 2
Cash Flows from Operating Activities		
Cash Receipts from Consulting Revenue		
Cash Payments for Expenses		
Net Cash Inflow from Operating Activities		
Cash Flows from Investing Activities		
Cash Payment to Purchase Land		
Cash Payment to Purchase Computer Equipment		
Cash Receipt from Sale of Land		
Net Cash Inflow (Outflow) from Investing Activities		
Cash Flows from Financing Activities		
Cash Receipt from Bank Loan		
Cash Receipt from Issuing Common Stock		
Cash Payment for Dividends		
Net Cash Inflow from Financing Activities		
Net Change in Cash		
Beginning Cash Balance		
Ending Cash Balance	$2,060	$7,475

Demonstration Problem 2-4: Requirement c
Year 1

Event No.	Balance Sheet			Income Statement			Statement of Cash Flow
	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	
1	+	NA	+	NA	NA	NA	+ FA
2							
3							
4							
5							
6							
7							
8							
9							
10							
11							
12							
13							
14							
15	NA	−	+	+	NA	+	NA

Demonstration Problem 2-4: Requirement c
Year 2

Event No.	Balance Sheet			Income Statement			Statement of Cash Flow
	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	
1	+	NA	+	NA	NA	NA	+ FA
2							
3							
4							
5							
6							
7							
8							
9							
10							
11							
12							
13							
14							
15							

Quiz Questions for Chapter 2

1. X Company recognized $500 of revenue on account and realized $400 of cash collections. The company had accrued salary expense of $300 and invested $200 in a certificate of deposit. Based on this information alone, the amount of cash flow from operating activities would be
   a. $100.
   b. $500.
   c. $200.
   d. $400.

2. On January 1, Year 1, West Company had accounts receivable of $500. During Year 1 West earned $2,500 of service revenue on account. If the accounts receivable balance as of December 31, Year 1, was $400, what was the amount of cash flow from operating activities?
   a. $2,000
   b. $3,000
   c. $2,400
   d. $2,600

3. The entry to record revenue on account
   a. increases liabilities.
   b. decreases equity.
   c. decreases assets.
   d. none of the above.

4. K Company collected $500 cash on an account receivable that was due from L Company. Based on this information, which of the following statements is true?
   a. K Company's total assets would increase.
   b. K Company's total assets would not change.
   c. K Company's equity would decrease.
   d. None of the above.

5. On April 1, Flavin Co. paid $12,000 cash for an insurance policy that provides coverage for one year beginning immediately. On December 31, Flavin adjusted the books to recognize the amount of the insurance policy used during the year. The amount of the adjustment would be:
   a. $8,000.
   b. $9,000.
   c. $12,000.
   d. $0.

6. Which of the following illustrates the recognition of revenue earned on account?

	Balance Sheet					Income Statement					Statement of Cash Flow
	Assets	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	
a.	+		NA		+	NA		NA		NA	NA
b.	+		NA		+	+		NA		+	NA
c.	−		NA		−	NA		+		−	− OA
d.	+		NA		+	+		NA		+	+ OA

Use the following information to answer the next two questions. BBC Company received $9,900 cash on February 1, Year 1, from XYZ Company as advance payment for services BBC promised to perform for XYZ over the next three years on a continuous basis. Assume that BBC Company's year-end is December 31.

7. On its Year 1 income statement, BBC would report revenue of
   a. $3,300.
   b. $9,900.
   c. $3,025.
   d. $2,750.

8. On its December 31, Year 2 balance sheet BBC would report liabilities of
   a. $3,575.
   b. $3,300.
   c. $9,900.
   d. $6,875.

9. Which of the following illustrates purchasing supplies on account?

	Balance Sheet					Income Statement					Statement of Cash Flow
	Assets	=	**Liab.**	+	**Equity**	**Rev.**	−	**Exp.**	=	**Net Inc.**	
a.	+		NA		+	NA		NA		NA	NA
b.	+		+		NA	NA		NA		NA	NA
c.	+		+		NA	NA		NA		NA	+ OA
d.	+		NA		+	+		NA		+	+ OA

10. Which of the following illustrates receiving cash as an advance payment for future services?

	Balance Sheet					Income Statement					Statement of Cash Flow
	Assets	=	**Liab.**	+	**Equity**	**Rev.**	−	**Exp.**	=	**Net Inc.**	
a.	+		NA		+	NA		NA		NA	NA
b.	+		+		NA	+		NA		+	NA
c.	+		+		NA	NA		NA		NA	+ OA
d.	+		NA		+	+		NA		+	+ OA

Quiz Answers

Question	Answer
1	D
2	D
3	D
4	B
5	B
6	B
7	C
8	A
9	B
10	C

Summary Outline of a Lesson Plan for Chapter 2

I. **Use Demonstration Problem 2-1 and 2-2 to define and illustrate the concept of accruals and deferrals.**

II. **Use separate examples from the text to further illustrate accrual and deferral concepts.**

III. **Use Demonstration Problem 2-3 as a comprehensive summary problem.** Explain the first cycle to the class and use the second cycle as an in-class assignment. Allot one hour for this assignment. Have slower students finish the problem as a home work assignment. Use problems 2-43A&B in the textbook as a homework assignment.

IV. **Time considerations and homework assignments.** Demonstration Problems 2-1 and 2-2 require approximately one hour of class time. Consider assigning exercises 2-12A&B, 2-19A&B, 2-20A&B, 2-3A&B, and Problem 2-39A&B from the textbook as homework.

V. **Use a financial statements model to highlight the differences between accrual and cash basis accounting.**

VI. **Hand out official answers to the Demonstration Problems worked in class.**

SOLUTIONS TO EXERCISES – SERIES A – CHAPTER 2

EXERCISE 2-1A

Holloway Company Effect of Events on the Year 1 Accounting Equation										
	Assets			=	Liabilities	+	Stockholders' Equity			
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue		+	18,000	=		+		+	18,000
Coll. Acct. Rec.	14,000	+	(14,000)	=		+		+	
Ending Balance	14,000	+	4,000	=	-0-	+	-0-	+	18,000

a. Accounts Receivable: $18,000 – $14,000 = $4,000

b. $18,000 Net Income

c. $14,000 cash collected from accounts receivable.

d. $18,000

e. $18,000 of revenue was earned but only $14,000 of it was collected.

EXERCISE 2-2A

a.

Chung Corporation Accounting Equation – Year 1							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.	8,000	=	NA	+	NA	+	8,000
Accrued Sal.	NA	=	5,000	+	NA	+	(5,000)
Ending Bal.	8,000	=	5,000	+	-0-	+	3,000

Chung Corporation Balance Sheet As of December 31, Year 1		
Assets		
Cash	$8,000	
Total Assets		$8,000
Liabilities		
Salaries Payable	$5,000	
Total Liabilities		$5,000
Stockholders' Equity		
Retained Earnings	$3,000	
Total Stockholders' Equity		3,000
Total Liab. and Stockholders' Equity		$8,000

b.

Computation of Net Income	
Revenue	$8,000
Less: Expenses	(5,000)
Net Income	$3,000

EXERCISE 2-2A (cont.)

c.

Cash Flow from Operating Activities	
Cash from Revenue	$8,000
Net Cash Flow from Operating Act.	$8,000

d. **The salary expense is deducted from revenue in computing net income, but it has not been paid. This creates a difference of $5,000 between net income and cash flow from operating activities. The revenue is the same because it has been earned and collected.**

EXERCISE 2-3A

a.

Milea Inc.
General Ledger Accounts
For the Year Ended December 31, Year 1

	Assets		=	Liabilities	+	Stockholders' Equity		
Event	Cash	Acct. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earn.	Acct. Title for RE
1.	20,000	NA	=	NA	+	20,000	NA	
2.	NA	56,000	=	NA	+	NA	56,000	Revenue
3.	(2,500)	NA	=	NA	+	NA	(2,500)	Util. Exp.
4.	48,000	(48,000)	=	NA	+	NA	NA	
5.	NA	NA	=	10,000	+	NA	(10,000)	Sal. Exp.
6.	(2,000)	NA	=	NA	+	NA	(2,000)	Dividends
Totals	63,500	8,000	=	10,000	+	20,000	41,500	

b.

Milea Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue		$56,000
Expenses		
Utility Expense	$ 2,500	
Salaries Expense	10,000	
Total Expenses		(12,500)
Net Income		$43,500

EXERCISE 2-3A b. (cont.)

Milea Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	20,000	
Ending Common Stock		$20,000
Beginning Retained Earnings	-0-	
Plus: Net Income	$43,500	
Less: Dividends	(2,000)	
Ending Retained Earnings		41,500
Total Stockholders' Equity		$61,500

Milea Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$63,500	
Accounts Receivable	8,000	
Total Assets		$71,500
Liabilities		
Salaries Payable	$10,000	
Total Liabilities		$10,000
Stockholders' Equity		
Common Stock	$20,000	
Retained Earnings	41,500	
Total Stockholders' Equity		61,500
Total Liab. and Stockholders' Equity		$71,500

EXERCISE 2-3A b. (cont.)

Milea Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flow From Operating Activities		
Cash Received from Customers	$48,000	
Cash Paid for Expenses	(2,500)	
Net Cash Flow from Operating Act.		$45,500
Cash Flow From Investing Activities		-0-
Cash Flow From Financing Activities		
Issue of Stock	$20,000	
Paid Dividends	(2,000)	
Net Cash Flow from Financing Act.		18,000
Net Change in Cash		63,500
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$63,500

c. Net income is the difference between services performed and expenses incurred, regardless of the cash collected or paid. Cash flow from operating activities is the difference between cash collected and paid for operating activities. There was $56,000 of income earned, but only $48,000 collected and $12,500 of expenses incurred, but there was only $2,500 paid.

EXERCISE 2-4A

a.

Lewis and Harper
Statements Model for Year 1

Event	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earn.	Rev.	–	Exp.	=	Net Inc.	Statement of Cash Flows
	Balance Sheet									Income Statement					
	Assets			=	Liabilities			+	S. Equity						
1.	NA	+	70,000	=	NA	+	NA	+	70,000	70,000	–	NA	=	70,000	NA
2.	40,000	+	NA	=	NA	+	NA	+	40,000	40,000	–	NA	=	40,000	40,000 OA
3.	NA	+	NA	=	36,000	+	NA	+	(36,000)	NA	–	36,000	=	(36,000)	NA
4.	(10,000)	+	NA	=	NA	+	NA	+	(10,000)	NA	–	10,000	=	(10,000)	(10,000) OA
5.	47,000	+	(47,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	47,000 OA
6.	(16,000)	+	NA	=	(16,000)	+	NA	+	NA	NA	–	NA	=	NA	(16,000) OA
7.	(8,000)	+	NA	=	NA	+	NA	+	(8,000)	NA	–	NA	=	NA	(8,000) FA
8.	NA	+	NA	=	NA	+	2,000	+	(2,000)	NA	–	2,000	=	(2,000)	NA
Totals	53,000	+	23,000	=	20,000	+	2,000	+	54,000	110,000	–	48,000	=	62,000	53,000 NC

b. Total assets: $76,000 ($53,000 + $23,000)
c. $23,000
d. $20,000
e. Accounts Receivable (an asset) is an amount owed to Lewis and Harper: $23,000; Accounts Payable (a liability) is an amount that Lewis and Harper owe: $20,000
f. $62,000

g. $61,000 ($40,000 – $10,000 + $47,000 – $16,000)

EXERCISE 2-5A

a.

Computation of Net Income	
Revenue recognized on account	$68,000
Less accrued salary expense	(46,000)
Net Income	$22,000

b.

Computation of Cash Collected from Accounts Receivable	
Beginning balance of Accounts Receivable	$ 4,000
Add revenue recognized on account	68,000
Less ending balance of Accounts Receivable	(4,500)
Cash collected from accounts receivable	$67,500

Computation of Cash Paid for Salaries Expense	
Beginning balance of Salaries Payable	$ 2,600
Add accrued salary expense recognized	46,000
Less ending balance of Salaries Payable	(1,500)
Cash paid for Salary Expense	$47,100

Cash Flow from Operating Activities	
Cash from Accounts Receivable	$67,500
Cash paid for Salary Expense	(47,100)
Net Cash Flow from Operating Act.	$20,400

EXERCISE 2-6A

a. & c.

Event	Revenue	Expense	Statement of Cash Flows
1.	NA	NA	$40,000 FA
2.	$82,000	NA	NA
3.	NA	NA	(6,000) FA
4.	NA	NA	76,000 OA
5.	NA	$53,000	(53,000) OA
6.	19,000	NA	19,000 OA
7.	NA	3,500	NA

b.

Computation of Net Income	
Revenue	$101,000
Less: Expenses	(56,500)
Net Income	$44,500

d.

Cash Flow from Operating Activities	
Cash from Revenue	$95,000
Cash paid for expenses	(53,000)
Net Cash Flow from Operating Act.	$42,000

e. The before-closing balance in the Revenue account is $101,000. After it is closed to Retained Earnings the balance will be zero.

f. The balance of Retained Earnings on the Year 1 Balance Sheet will be the amount of Net Income, $44,500 minus $6,000 of dividends that were paid during the year = $38,500. There was no beginning balance in Retained Earnings.

EXERCISE 2-7A

Lee Inc. Effect of Events on the General Ledger Accounts										
	Assets			=	Liabilities	+	Stockholders' Equity			
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings	
1. Sales on Account	NA	72,000	NA	=	NA	+	NA	+	72,000	
2. Coll. Accts. Rec.	55,000	(55,000)	NA	=	NA	+	NA	+	NA	
3. Incurred Expense	NA	NA	NA	=	42,000	+	NA	+	(42,000)	
4. Pd. Acc. Pay.	(34,000)	NA	NA	=	(34,000)	+	NA	+	NA	
5. Issue of Stock	44,000	NA	NA	=	NA	+	44,000	+	NA	
6. Purchase Land	(18,000)	NA	18,000	=	NA	+	NA	+	NA	
Totals	47,000	17,000	18,000	=	8,000	+	44,000	+	30,000	

a. Revenue recognized, $72,000.

b. Cash flow from revenue, $55,000.

c. Revenue, $72,000, less operating expenses, $42,000 = $30,000 net income.

d. Accounts receivable collected, $55,000, less cash paid for expenses, $34,000 = $21,000 cash flow from operating activities.

e. Income of $72,000 was earned, but only $55,000 was collected (a difference of $17,000); operating expenses incurred were $42,000 but only $34,000 was paid during the period (a difference of $8,000). Consequently, net income is $9,000 more than cash flow from operating activities.

f. $18,000 cash outflow for the purchase of land.

g. $44,000 cash inflow from the issue of common stock.

h. Total assets = $82,000 ($47,000 + $17,000 + $18,000)
Total liabilities = $8,000
Total equity = $74,000 ($44,000 + $30,000)

EXERCISE 2-8A

a. Retained Earnings is a permanent account, meaning that one period's ending balance becomes the next period's beginning balance. Since the December 31, Year 2 balance is $42,100, this was also the balance on January 1, Year 3.

b. The balance in the temporary accounts will be zero on January 1, Year 2. The temporary accounts would have been closed to Retained Earnings in the prior year thus leaving a zero balance.

c. The December 31, Year 1 balance in the Retained Earnings account is the same balance as the January 1, Year 2 balance, computed as follows:

Beginning Retained Earnings Balance, January 1, Year 2	$?
+ Net Income (Revenue $19,400 – Expenses $9,800)	9,600
– Dividends	(500)
= Ending Retained Earnings Balance, December 31, Year 2	$42,100

Working backwards:
End. Retained Earnings + Dividends – Net Income = Beg. Retained Earnings; and January 1, Year 2 = December 31, Year 1 = $42,100 + $500 – $9,600 = $33,000 = January 1, Year 2 Retained Earnings
Therefore:
December 31, Year 1 Retained Earnings = $33,000

d. The revenue and expense data are recorded in Revenue and Expense accounts and do not affect retained earnings at the time of recognition. The balance in the Retained Earnings account on June 30, Year 2 is the same as it was on January 1, Year 2 which is $33,000 (see answer (c) for calculation).

EXERCISE 2-9A

a.

Permanent Accounts
Cash
Notes Payable
Land
Common Stock
Retained Earnings

Temporary (Nominal) Accounts
Revenue
Expenses
Dividends

b.

Beginning Retained Earnings	$2,500
Add: Revenue	7,500
Less: Expenses	(3,400)
Less: Dividends	(1,000)
Ending Retained Earnings	$5,600

c.

Computation of Net Income	
Revenue	$7,500
Less: Expenses	(3,400)
Net Income	$4,100

d. Net income is only the current year's net income. Retained Earnings is an accumulation of net income over the life of the business less any dividends that have been paid over the years.

e. All revenue, expense and dividends accounts will have a zero balance because they have been closed to retained earnings.

EXERCISE 2-10A

a.

	Account	Classification
1.	Other Operating Expense	T
2.	Utilities Expense	T
3.	Retained Earnings	P
4.	Salaries Expense	T
5.	Land	P
6.	Dividends	T
7.	Service Revenue	T
8.	Cash	P
9.	Salaries Payable	P
10.	Common Stock	P

b. The four stages of the accounting cycle are:
recording transactions
adjusting the accounts
preparing financial statements
closing temporary accounts.

The first stage of the cycle must be recording accounting data in accounts to put it into usable form. Once the accounting data is summarized in the accounts, adjustments are made to reflect any unrecorded transactions. The account balances are then used to prepare the financial statements. After the financial statements are prepared, the temporary accounts (revenue, expenses, and dividends) must be closed to prepare these accounts for the next accounting period.

EXERCISE 2-11A

a. **Examples of expenses that would be matched directly with revenue:**
   Sales commissions
   Salaries expense

b. **An example of a period cost that is difficult to match with revenue:**
   Advertising expense - A company cannot be certain when dollars spent for advertising will produce benefits.

EXERCISE 2-12A

a.

Pizza Express
Effect of Events on Financial Statements for Year 2

	Assets			=	Liab.	+	Stockholders' Equity			Income Statement					Statement of
Event	Cash	+	Supplies	=	Accts. Pay.	+	Com. Stock	+	Ret. Earn.	Rev.	–	Exp.	=	Net Income	Cash Flows
Beg.	2,500	+	-0-	=	-0-	+	1,400	+	1,100	-0-	–	-0-	=	-0-	-0-
1.	NA	+	3,600	=	3,600	+	NA	+	NA	NA	–	NA	=	NA	NA
2.	12,300	+	NA	=	NA	+	NA	+	12,300	12,300	–	NA	=	12,300	12,300 OA
3.	(2,700)	+	NA	=	(2,700)	+	NA	+	NA	NA	–	NA	=	NA	(2,700) OA
4.	NA	+	(3,350)	=	NA	+	NA	+	(3,350)	NA	–	3,350	=	(3,350)	NA
Totals	12,100	+	250	=	900	+	1,400	+	10,050	12,300	–	3,350	=	8,950	9,600 NC

b. The difference in net income and cash flow from operating activities of $650 ($8,950 – $9,600) is attributed to recognizing supplies expense of $3,350 in the income statement, whereas the cash payment on accounts payable (for supplies) was only $2,700.

EXERCISE 2-13A

a.

Yard Professionals Inc.
Effect of Events on the Accounting Equation

	Assets		=	Liab.	+	Stk. Equity
Event	Cash	Supplies	=	Accounts Payable	+	Retained Earnings
1. Provided Service	35,000	NA	=	NA	+	35,000
2. Purchased Supplies	NA	6,000	=	6,000	+	NA
3. Used Supplies	NA	(4,200)	=	NA	+	(4,200)
Totals	35,000	1,800	=	6,000	+	30,800

b.

Yard Professionals Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue	$35,000
Expense	(4,200)
Net Income	$30,800

EXERCISE 2-13A b. (cont.)

Yard Professionals Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$35,000	
Supplies	1,800	
Total Assets		$36,800
Liabilities		
Accounts Payable	$ 6,000	
Total Liabilities		$ 6,000
Stockholders' Equity		
Retained Earnings	30,800	
Total Stockholders' Equity		30,800
Total Liab. and Stockholders' Equity		$36,800

Yard Professionals Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$35,000	
Net Cash Flow from Operating Activities		$35,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		35,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$35,000

EXERCISE 2-13A (cont.)

c. **The balance of the Supplies account on January 1, Year 2 is $1,800 the same as the December 31, Year 1 balance.**

d. **The balance of the Supplies Expense account on January 1, Year 2 is zero because the expense account was closed to Retained Earnings at December 31, Year 1.**

EXERCISE 2-14A

a. A <u>cost</u> is the value sacrificed for goods and services that are expected to bring a current or future benefit to the organization. A cost can be either an asset or expense.

Costs that are incurred to produce future benefits are classified as assets. In a profit-making firm, future benefits usually mean revenues. As costs are used up in the production of revenues, they are said to expire. Expired costs are called <u>expenses</u>. In each period, expenses are deducted from revenues in the income statement to determine the period's profits. Once the benefit has been obtained, the cost is classified as an expense.

b.

	Asset	Expense
(1)	X (Purchased Building)	
(2)	X (Purchased Supplies)	
(3)		X (Used Supplies)
(4)	X (Paid Insurance in Advance)	
(5)		X (Accrued Salaries)

EXERCISE 2-15A

a.

Life, Inc.
Effect of Events on the Accounting Equation

	Assets		=	Stockholders' Equity
Event	Cash	Prepaid Rent	=	Retained Earnings
1. Performed Services	36,000	NA	=	36,000
2. Prepaid Rent	(18,000)	18,000	=	NA
3. Used Rent	NA	(16,500)*	=	(16,500)
Totals	18,000	1,500	=	19,500

*$18,000 x 11/12 = $16,500

b.

Life, Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue	$36,000
Expense	(16,500)
Net Income	$19,500

Life, Inc.
Balance Sheet
As of December 31, Year 1

Assets		
Cash	$18,000	
Prepaid Rent	1,500	
Total Assets		$19,500
Liabilities		-0-
Stockholders' Equity		
Retained Earnings	19,500	
Total Stockholders' Equity		19,500
Total Liab. and Stockholders' Equity		$19,500

EXERCISE 2-15A (cont.)

b.

Life, Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$36,000	
Cash Payment for Rent	(18,000)	
Net Cash Flow from Operating Activities		$18,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		18,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$18,000

c. The balance of the Prepaid Rent will be expensed in Year 2, $1,500.

EXERCISE 2-16A

a.

Maine Corporation Accounting Equation Year 1								
	Assets		=	Liab.	+	Stockholders' Equity		
Event	Cash	Prepaid Rent	=		+	Com. Stock	+	Retained Earnings
Paid rent in advance	(18,000)	18,000	=	NA	+	NA	+	NA
Adj. Rent exp.	NA	(13,500)*	=	NA	+	NA	+	(13,500)
Totals	(18,000)	4,500	=	-0-	+	-0-	+	(13,500)

*$18,000 x 9/12 = $13,500

b. The required entry would decrease assets by $13,500 [($18,000 ÷ 12) x 9] and decrease stockholders' equity by $13,500 (retained earnings). If this entry is not made, assets and stockholders' equity would both be overstated on the balance sheet by $13,500. On the income statement, expenses would be understated causing net income to be overstated by $13,500.

EXERCISE 2-17A

a.

Yard Designs Year 1					
Event	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Unearned Revenue	+	Retained Earnings
event	54,000	=	54,000	+	NA
Adj.	NA	=	(13,500)*	+	13,500
	54,000	=	40,500	+	13,500

*$54,000 x 3/12 = $13,500

b.

Yard Designs Income Statement For the Year Ended December 31, Year 1	
Revenue	$13,500
Expense	-0-
Net Income	$13,500

Yard Designs Balance Sheet As of December 31, Year 1		
Assets		
Cash	$54,000	
Total Assets		$54,000
Liabilities		-0-
Unearned Revenue	$40,500	
Total Liabilities		$40,500
Stockholders' Equity		
Retained Earnings	13,500	
Total Stockholders' Equity		13,500
Total Liab. and Stockholders' Equity		$54,000

EXERCISE 2-17A (cont.)

b.

Yard Designs Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$54,000	
Net Cash Flow from Operating Activities		$54,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		54,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$54,000

c. Nine months of unearned revenue from Year 1 will be recognized in Year 2: $54,000 x 9/12 = $40,500

EXERCISE 2-18A

Note: This exercise can be used to assess writing skills.

The fee that Matlock receives in advance is a liability at the time of receipt. Matlock has the duty to either perform the service or return the money received in advance. When Matlock performs the service, the liability will be satisfied and the revenue will be recognized.

EXERCISE 2-19A

Hart Attorney At Law Effect of Transactions on the Financial Statements for Year 1															
	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liabilities			+	S. Equity	Rev	–	Exp.	=	Net Inc.	
Event	Cash	+	Supplies	=	Accts. Payable	+	Unearn. Rev.	+	Retained Earnings						
1.	36,000	+	NA	=	NA	+	36,000	+	NA	NA	–	NA	=	NA	36,000 OA
2.	54,000	+	NA	=	NA	+	NA	+	54,000	54,000	–	NA	=	54,000	54,000 OA
3.	NA	+	2,800	=	2,800	+	NA	+	NA	NA	–	NA	=	NA	NA
4.	(2,400)	+	NA	=	(2,400)	+	NA	+	NA	NA	–	NA	=	NA	(2,400) OA
5.	(5,000)	+	NA	=	NA	+	NA	+	(5,000)	NA	–	NA	=	NA	(5,000) FA
6.	(31,000)	+	NA	=	NA	+	NA	+	(31,000)	NA	–	31,000	=	(31,000)	(31,000) OA
7.	NA	+	(2,600)	=	NA	+	NA	+	(2,600)	NA	–	2,600	=	(2,600)	NA
8.	NA	+	NA	=	NA	+	(27,000)*	+	27,000	27,000	–	NA	=	27,000	NA
Totals	51,600	+	200	=	400	+	9,000	+	42,400	81,000	–	33,600	=	47,400	51,600 NC

*$36,000 x 9/12 = $27,000

EXERCISE 2-20A

a.

Bell Personal Financial Planning
Horizontal Statements Model for Year 1

	Assets	=	Liabilities	+	Stk. Equity	Income Statement					Statement of Cash Flows
Event	Cash	=	Unearned Revenue	+	Retained Earnings	Rev.	–	Exp.	=	Net Income	
1. Advance Payment	36,000	=	36,000	+	NA	NA	–	NA	=	NA	36,000 OA
2. Revenue Earned	NA	=	(21,000)*	+	21,000	21,000	–	NA	=	21,000	NA
Totals	36,000	=	15,000	+	21,000	21,000	–	-0-	=	21,000	36,000 NC

*$36,000 x 7/12 = $21,000

b. Revenue that will be recognized in Year 2 is $15,000, the remainder of the unearned revenue from Year 1.

c. $-0-, no cash is received. All cash was received in Year 1.

EXERCISE 2-21A

a.

Josh Smith Attorney - Year 1							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Unearned Revenue	+	Common Stock	+	Retained Earnings
Cash collected	10,800	=	10,800	+	NA	+	NA
Revenue earned	NA	=	(5,400)*	+	NA	+	5,400

*$10,800 x 3/6 = $5,400

b.

James Company - Year 1								
Event	Assets		=	Liab.	+	Stockholders' Equity		
	Cash	Prepaid Legal Fees	=		+	Common Stock	+	Retained Earnings
Cash paid	(10,800)	10,800	=	NA	+	NA	+	NA
Service used	NA	(5,400)*	=	NA	+	NA	+	(5,400)

*$10,800 x 3/6 = $5,400

EXERCISE 2-22A

a. deferral

b. neither

c. neither

d. neither

e. deferral

f. accrual

g. neither

h. neither

i. accrual

j. neither

k. accrual

l. deferral

EXERCISE 2-23A

Note: There are many examples of events that illustrate the required effects. An example is given of each event.

a. Recognized accrued salaries expense.

b. Paid rent expense.

c. Recognized revenue for which cash had been received in advance (unearned revenue).

d. Provided service for cash.

EXERCISE 2-24A

a.

Event	Requires year-end adjusting entry?
1.	No
2.	No
3.	Yes
4.	Yes
5.	No
6.	Yes
7.	No
8.	No
9.	No
10.	No

b. Adjusting entries are required to update accounting records for income that has been earned or expenses that have been incurred. Revenue and expenses are recognized in the period that they are earned or incurred, not necessarily when the cash is received or paid.

EXERCISE 2-25A

a.

Event	Classification
1.	FA
2.	NA
3.	OA
4.	OA
5.	OA
6.	NA
7.	OA
8.	FA
9.	OA
10.	NA

b.

Ewing Company Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash from the collection of accts. rec.	$51,000	
Cash from service revenue	8,000	
Cash payment for supplies	(1,200)	
Cash payment on accounts payable	(22,000)	
Cash payment for rent	(6,500)	
Net Cash Flow from Operating Activities		$29,300
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		
Cash receipt from stock issue	$30,000	
Cash payment for dividends	(4,000)	
Net Cash Flow from Financing Activities		26,000
Net Change in Cash		$55,300
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$55,300

EXERCISE 2-26A

Item/Account		Statement	Item/Account		Statement
a.	Supplies	BS	u.	Rent Exp.	IS
b.	Cash Flow from Financing Act.	CF	v.	P/E Ratio	NA
c.	"As of" Date Notation	BS	w.	Taxes Payable	BS
d.	End Retained Earn.	BS/SE	x.	Unearned Revenue	BS
e.	Net Income	IS/SE	y.	Service Revenue	IS
e.	Dividends	SE/CF	z.	Cash Flow from Investing Activities	CF
g.	Net Change in Cash	CF	aa.	Consulting Revenue	IS
h.	"For the Period Ended"	IS, CF,SE	bb.	Utilities Expense	IS
i.	Land	BS	cc.	Total Liabilities	BS
j.	Ending Common Stock	BS,SE	dd.	Operating Cycle	NA
k.	Salaries Expense	IS	ee.	Cash Flow from Operating Activities	CF
l.	Prepaid Rent	BS	ff.	Operating Expenses	IS
m.	Accounts Payable	BS	gg.	Supplies Expense	IS
n.	Total Assets	BS	hh.	Beg. Retained Earn.	SE
o.	Salaries Payable	BS	ii.	Beg. Common Stock	SE
p.	Insurance Expense	IS	jj.	Prepaid Insurance	BS
q.	Notes Payable	BS	kk.	Salary Expense	IS
r.	Accounts Receivable	BS	ll.	Beginning Cash	CF
s.	Interest Receivable	BS	mm.		BS/CF
t.	Interest Revenue	IS			

EXERCISE 2-27A

	Net Income		Cash Flow from Operating Activities	
Event/Adj.	Direction of Change	Amount of Change	Direction of Change	Amount of Change
a. Event Adj.	NA Decrease	NA $2,250[1]	Decrease NA	$9,000 NA
b. Event Adj.	NA Decrease	NA 1,700[2]	Decrease NA	500 NA
c. Event No adj.	Increase	10,000	Increase	10,000
d. Event Adj.	NA Increase	NA 1,600[3]	Increase NA	2,400 NA
e. Event No adj.	Decrease	5,600	NA	NA
f. Event No adj.	NA	NA	NA	NA
g. Event No adj.	NA	NA	NA	NA
h. Event No adj.	Increase	12,000	Increase	8,000
i. Event No adj.	Decrease	4,500	Decrease	4,500

[1]$9,000 x 3/12 = $2,250
[2]$2,000 – $300 = $1,700
[3]$2,400 x 8/12 = $1,600

EXERCISE 2-28A

The following are only example transactions. There are also other transactions that would cause the desired effect.

a. The business acquired cash by issuing stock to its owners.

Cash revenue is earned.

b. Paid cash dividends to stockholders.

Paid an expense with cash.

c. The business invested cash by purchasing a building.

Collected accounts receivable.

d. Unearned revenue is earned and recognized.

e. Recorded accrued salaries.

Recorded the expense for the utility bill received at the end of the month, but not due until next month.

f. Received cash in advance for services to be provided in the future.

Borrowed cash from the bank.

g. Paid cash for operating expenses previously purchased on account.

Repaid a loan with cash.

EXERCISE 2-29A

a. Asset Source

b. Asset Use

c. Asset Use

d. Claims Exchange

e. Asset Use

f. Asset Source

g. Asset Source

h. Asset Exchange

i. Asset Source

j. Asset Exchange

EXERCISE 2-30A

Note: These are only sample transactions. Other similar transactions will satisfy the requirements of this exercise.

a. **Payment of a bank loan; payment of accounts payable.**

b. **Collection of accounts receivable; purchase of Land.**

c. **Borrowed cash from the bank; issued stock for cash.**

d. **Provide service on account.**

e. **Provide service for cash; provide service on account.**

EXERCISE 2-31A

Horizontal Statements Model															
						Stock. Equity			Income Statement					Statement of Cash Flows	
Event	Type of Event	Assets	=	Liab.	+	Com. Stock	+	Ret. Earn	Rev.	–	Exp	=	Net Inc.		
a.	AS	I	=	NA	+	NA	+	I	I	–	NA	=	I	I	OA
b.	AS	I	=	I	+	NA	+	NA	NA	–	NA	=	NA	NA	
c.	AE	I/D	=	NA	+	NA	+	NA	NA	–	NA	=	NA	D	OA
d.	AE	I/D	=	NA	+	NA	+	NA	NA	–	NA	=	NA	D	IA
e.	AU	D	=	NA	+	NA	+	D	NA	–	NA	=	NA	D	FA
f.	AS	I	=	NA	+	I	+	NA	NA	–	NA	=	NA	I	FA
g.	AU	D	=	D	+	NA	+	NA	NA	–	NA	=	NA	D	OA
h.	AE	I/D	=	NA	+	NA	+	NA	NA	–	NA	=	NA	I	OA
i.	AS	I	=	I	+	NA	+	NA	NA	–	NA	=	NA	I	OA
j.	CE	NA	=	I	+	NA	+	D	NA	–	I	=	D	NA	
k.	AS	I	=	NA	+	NA	+	I	I	–	NA	=	I	NA	
l.	AU	D	=	NA	+	NA	+	D	NA	–	I	=	D	NA	
m.	AU	D	=	NA	+	NA	+	D	NA	–	I	=	D	D	OA
n.	AU	D	=	NA	+	NA	+	D	NA	–	I	=	D	NA	
o.	CE	NA	=	I	+	NA	+	D	NA	–	I	=	D	NA	
p.	AU	D	=	D	+	NA	+	NA	NA	–	NA	=	NA	D	OA
q.	AS	I	=	NA	+	NA	+	I	I	–	NA	=	I	NA	

EXERCISE 2-32A

The six principles of the AICPA Code of Professional Conduct and a brief explanation is as follows:

Responsibilities Principle

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

The Public Interest Principle

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

Integrity Principle

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

Objectivity and Independence Principle

A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

Due Care Principle

A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

Scope and Nature of Services Principle

A member in public practice should observe the principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

EXERCISE 2-33A (Appendix)

a.

Tracey's Restaurant
Accounting Equation for Year 1

	Assets			=	Stockholders' Equity		
Event	Cash	Cook Top	Accum. Depr.	=	Com. Stock	+	Retained Earnings
1. Issue Stk.	21,000	NA	NA	=	21,000	+	NA
2. Pur. Cooktop	(22,000)	22,000	NA	=	NA	+	NA
3. Rev.	32,000	NA	NA	=	NA	+	32,000
4. Paid Sal Exp.	(16,000)	NA	NA	=	NA	+	(16,000)
5. Paid Op. Exp.	(7,000)	NA	NA	=	NA	+	(7,000)
6. Depr. Exp.	NA	NA	(4,000)*	=	NA	+	(4,000)
Totals	8,000	22,000	(4,000)	=	21,000	+	5,000

*(22,000 − $2,000) ÷ 5 = $4,000 depreciation per year

b. $4,000 for Year 2 and each year of the cooktop's useful life.

c. $8,000 of accumulated depreciation ($4,000 for Year 1 + $4,000 for Year 2).

d. No, because depreciation is a non-cash expense. Depreciation is the systematic allocation of the cost of an asset to expense. The cash payment occurred when the cooktop was purchased.

EXERCISE 2-34A (Appendix)

a. Compute the depreciation expense per year.

(Cost – Salvage) ÷ Useful Life = Depreciation expense per year.

($36,000 – $4,000) ÷ 4 = $8,000 per year

Depreciation expense for Year 1 = $8,000
Depreciation expense for Year 2 = $8,000

b. Accumulated Depreciation for Year 1 is $8,000.
Accumulated Depreciation for Year 2 is $16,000 ($8,000 depreciation expense for Year 1 and $8,000 depreciation expense for Year 2.)

c. The statement of cash flows is only affected in Year 1 by the purchase of the taxi cab. It would show an outflow of $36,000 as an investing activity. There is no cash activity associated with the depreciation expense.

EXERCISE 2-35A (Appendix)

a. $8,000 x 6% = $480; $480 x 5/12 = $200

b. $-0-, no interest was paid in Year 1; $480 of interest will be paid in Year 2.

c.

Bradley Company
Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
Event	Assets	=	Liabilities			+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	
No.	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.						
1.	I	=	NA	+	NA	+	NA	+	I	I	−	NA	=	I	I OA
2.	I	=	I	+	NA	+	NA	+	NA	NA	−	NA	=	NA	I FA
3.	NA	=	NA	+	I	+	NA	+	D	NA	−	I	=	D	NA

EXERCISE 2-36A (Appendix)

a. Interest expense recognized for Year 1: $80,000 x 8% = $6,400; $6,400 x 7/12 = $3,733 (rounded)

b.

Leach Company Accounting Equation for Year 1									
	Assets	=	Liabilities			+	Equity		
Event	Cash		Note Payable	+	Interest Payable		Common Stock	+	Retained Earnings
Note	80,000	=	80,000	+	NA	+	NA		NA
Adj.	NA		NA		3,733		NA		(3,733)

See the adjusting entry in the accounting equation above (liabilities increase, equity decreases).

c. $-0-. All interest will be paid at maturity, June 1, Year 2, for this note payable.

d. $3,733

e. $6,400 ($80,000 x 8%). All interest will be paid when the note payable matures.

f. $2,667 ($80,000 x 8% x 5/12) or ($6,400 – $3,733 = $2,667)

g. $-0-

SOLUTIONS TO PROBLEMS – SERIES A

PROBLEM 2-37A

The Accounting Equation									
	Total Assets			=	Liabilities	+	Stockholders' Equity		
Event/ Adjust.	Cash	+	Other Assets	=		+	Common Stock	+	Retained Earnings
a.	(4,800)	+	+4,800	=	NA	+	NA	+	NA
a. Adj.	NA	+	(1,200)[1]	=	NA	+	NA	+	(1,200)
b.	+3,600	+	NA	=	+3,600	+	NA	+	NA
b. Adj.	NA	+	NA	=	(2,700)[2]	+	NA	+	+2,700
c.	NA	+	+1,200	=	+1,200	+	NA	+	NA
c. Adj.	NA	+	(1,025)	=	NA	+	NA	+	(1,025)
d.	(9,600)	+	+9,600	=	NA	+	NA	+	NA
d. Adj.	NA	+	(4,000)[4]	=	NA	+	NA	+	(4,000)

[1]$4,800 x 3/12 = $1,200
[2]$3,600 x 9/12 = $2,700
[3]$1,200 – $175 = $1,025
[4]$9,600 x 5/12 = $4,000

PROBLEM 2-38A

a.

Nowell Company Income Statement For the Year Ended December 31, Year 2		
Consulting Revenue		$18,200
Expenses		
Travel Expense	$2,100	
Rent Expense	3,500	
Salary Expense	7,200	
Other Operating Expenses	2,300	
Total Expenses		(15,100)
Net Income		$3,100

b.

Accounts to be Closed:
Consulting Revenue
Travel Expense
Dividends
Rent Expense
Salary Expense
Other Operating Expenses

PROBLEM 2-38A (cont.)

c.

Computation of Retained Earnings:	
Beginning Retained Earnings	$16,200
Add: Net Income	3,100
Less: Dividends	(4,000)
Ending Retained Earnings	$15,300

Net income only includes revenues and expenses for the current year. Retained earnings not only includes current year net income, but also the balance from previous years and reductions for dividends.

d. The balances are zero; they were closed to Retained Earnings on December 31, Year 2. The December 31 closing balance of one year is the opening balance on January 1 of the next year.

PROBLEM 2-39A

Super Cleaning Co. Effect of Events on the Financial Statements																			
	Balance Sheet													Income Statement					Stmt. of Cash Flows
	Assets					=	Liabilities			+	Stockholders' Equity			Rev.	–	Exp.	=	Net Inc.	
Event No.	Cash	+	Accts Rec.	+	Pp. Rent	=	Accts. Pay.	+	Unearn Rev.	+	Com. Stock	+	Ret. Earn.						
1.	10,000	+	NA	+	NA	=	NA	+	NA	+	10,000	+	NA	NA	–	NA	=	NA	10,000 FA
2.	NA	+	15,000	+	NA	=	NA	+	NA	+	NA	+	15,000	15,000	–	NA	=	15,000	NA
3.	5,000	+	NA	+	NA	=	NA	+	NA	+	NA	+	5,000	5,000	–	NA	=	5,000	5,000 OA
4.	2,800	+	NA	+	NA	=	NA	+	2,800	+	NA	+	NA	NA	–	NA	=	NA	2,800 OA
5.	12,200	+	(12,200)	+	NA	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	12,200 OA
6.	(1,900)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(1,900)	NA	–	1,900	=	(1,900)	(1,900) OA
7.	NA	+	NA	+	NA	=	NA	+	(1,400)	+	NA	+	1,400	1,400	–	NA	=	1,400	NA
8.	NA	+	NA	+	NA	=	3,600	+	NA	+	NA	+	(3,600)	NA	–	3,600	=	(3,600)	NA
9.	(4,800)	+	NA	+	4,800	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(4,800) OA
10.	(2,800)	+	NA	+	NA	=	(2,800)	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(2,800) OA
11.	(1,500)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(1,500)	NA	–	NA	=	NA	(1,500) FA
12.	NA	+	NA	+	(3,600)*	=	NA	+	NA	+	NA	+	(3,600)	NA	–	3,600	=	(3,600)	NA
Bal.	19,000	+	2,800	+	1,200	=	800	+	1,400	+	10,000	+	10,800	21,400	–	9,100	=	12,300	19,000 NC

*$4,800 x 9/12 = $3,600

PROBLEM 2-40A

Accounting Equation (Prepared for Instructor's Use)

	Accounting Equation									
	Assets					Liabilities			Stk. Equity	
Date	Cash	Acc Rec.	Pp. Rent	Supp.	Land	Acc. Pay.	Sal. Pay.	Unear. Rev.	Com. Stock	Ret. Earn
Bal.	35,000	9,000			51,000	7,500			40,000	47,500
1/1	20,000								20,000	
2/1	(6,000)		6,000							
3/1	(2,000)									(2,000)
4/1	(15,000)				15,000					
5/1	(5,500)					(5,500)				
7/1	9,600							9,600		
9/1	30,000				(30,000)					
10/1				2,500		2,500				
12/31		58,000								58,000
12/31	46,000	(46,000)								
12/31						28,000				(28,000)
12/31							6,500			(6,500)
12/31				(2,450)						(2,450)
12/31[1]										
12/31a			(5,500)[2]							(5,500)
12/31a								(4,800)[3]		4,800
Bal.	112,100	21,000	500	50	36,000	32,500	6,500	4,800	60,000	65,850

[1] 12/31 No entry required for the change in the value of the land.
[2] 12/31a Expired Rent $6,000 x 11/12 = $5,500
[3] 12/31a Unearned Revenue earned $9,600 x 6/12 = $4,800

PROBLEM 2-40A (cont.)

a. **$36,000; its historical cost.**

b. **$46,000 + $9,600 – $6,000 – $5,500 = $44,100**

c. **$6,000 X 11/12 = $5,500**

d. **$32,500 + $6,500 + $4,800 = $43,800**

e. **$2,500 – $50 = $2,450**

f. **$9,600 – $4,800 ($9,600 x 6/12) = $4,800**

g. **$(15,000) + $30,000 = $15,000**

h. **$28,000 + $6,500 + $2,450 + $5,500 = $42,450**

i. **$58,000 + $4,800 = $62,800**

j. **$20,000 – $2,000 = $18,000**

k. **(j) $62,800 – (i) $42,450 = $20,350**

l. **Beg. RE $47,500 + NI $20,350 – Div. $2,000 = Ending retained earnings $65,850**

PROBLEM 2-41A

Barker Company Financial Statements For the Year Ended December 31, Year 2		
Income Statement		
Revenue		
Service Revenue	$65,200	
Total Revenue		$65,200
Expenses		
Other Operating Expenses	$41,000	
Supplies Expense	1,100	
Rent Expense	2,500	
Insurance Expense	2,100	
Total Expenses		(46,700)
Net Income		$18,500
Statement of Changes in Stockholders' Equity		
Beginning Common Stock	$40,000	
Plus: Stock Issued	5,000	
Ending Common Stock		$45,000
Beginning Retained Earnings	$ 9,300	
Plus: Net Income	18,500	
Less: Dividends	(3,000)	
Ending Retained Earnings		24,800
Total Stockholders' Equity		$69,800

PROBLEM 2-41A (cont.)

Barker Company Balance Sheet As of December 31, Year 2		
Assets		
Cash		$ 48,000
Accounts Receivable		14,200
Supplies		1,000
Prepaid Insurance		1,200
Prepaid Rent		4,800
Land		24,000
Total Assets		$93,200
Liabilities		
Accounts Payable	$17,000	
Unearned Revenue	6,400	
Total Liabilities		$23,400
Stockholders' Equity		
Common Stock	$45,000	
Retained Earnings	24,800	
Total Stockholders' Equity		69,800
Total Liab. and Stockholders' Equity		$93,200

PROBLEM 2-41A (cont.)

Barker Company Statement of Cash Flows For the Year Ended December 31, Year 2	
Cash Flow From Operating Activities	$15,600
Cash Flow From Investing Activities	(5,200)
Cash Flow From Financing Activities	(5,000)
Net Change in Cash	5,400
Plus: Beginning Cash Balance	42,600*
Ending Cash Balance	$48,000

*Not given in the problem.

Ending Cash Balance – Increase in Cash = Beginning Cash Balance
$48,000 – $5,400 = $42,600

PROBLEM 2-42A

FOR THE YEARS	Year 1	Year 2	Year 3
Income Statements			
Revenue (cash)	$ 700	$1,300	$ 2,000
Expense (cash)	(a) (500)	(700)	(1,300)
Net Income (Loss)	$ 200	(m) $ 600	$ 700
Statements of Changes in Stockholders' Equity			
Beginning Common Stock	$ -0-	(n) $5,000	$6,000
Plus: Common Stock Issued	5,000	1,000	2,000
Ending Common Stock	5,000	6,000	(t) 8,000
Beginning Retained Earnings	-0-	100	200
Plus: Net Income (Loss)	(b) 200	(o) 600	700
Less: Dividends	(c) (100)	(500)	(300)
Ending Retained Earnings	100	(p) 200	600
Total Stockholders' Equity	(d) $5,100	$6,200	$8,600
Balance Sheets			
Assets			
Cash	(e) $8,100	(q) $3,200	(u)$ 2,600
Land	-0-	(r) 8,000	8,000
Total Assets	(f) $8,100	$11,200	$10,600
Liabilities	(g) $3,000	$ 5,000	$ 2,000
Stockholders' Equity			
Common Stock	(h) 5,000	(s) 6,000	8,000
Retained Earnings	(i) 100	200	600
Total Stockholders' Equity	(j) 5,100	6,200	8,600
Total Liab. and Stk. Equity	$8,100	$11,200	$10,600

PROBLEM 2-42A (cont.)

FOR THE YEARS	Year 1	Year 2	Year 3
Statements of Cash Flows			
Cash Flows From Oper. Activities:			
Cash Receipts from Customers	(k)$ 700	$ 1,300	(v) $ 2,000
Cash Payments for Expenses	(l) (500)	(700)	(w) (1,300)
Net Cash Flows from Oper. Act.	200	600	700
Cash Flows From Invest. Activities:			
Cash Payments for Land	-0-	(8,000)	-0-
Cash Flows From Fin. Activities:			
Cash Receipts from Loan	3,000	3,000	-0-
Cash Payments to Reduce Debt	-0-	(1,000)	(x) (3,000)
Cash Receipts from Stock Issue	5,000	1,000	(y) 2,000
Cash Payments for Dividends	(100)	(500)	(z) (300)
Net Cash Flows from Fin. Activities	7,900	2,500	(1,300)
Net Change in Cash	8,100	(4,900)	(600)
Plus: Beginning Cash Balance	-0-	8,100	3,200
Ending Cash Balance	$8,100	$3,200	$2,600

PROBLEM 2-42A (cont.)

Computations of amounts:

a. $500 Expense = $700 Revenue – $200 Net Income.
b. $200 Net Income = $200 Net Income from Income Statement.
c. $100 Dividends = $200 Net Income – $100 Ending Ret. Earnings.
d. $5,100 Total Stk. Equity = $5,000 Ending Common Stock +$100 Ending Retained Earnings.
e. $8,100 Cash = $8,100 Total Assets – $-0- Land.
f. $8,100 Total Assets = $8,100 Liabilities and Stockholders' Equity.
g. $3,000 Liabilities = $3,000 Cash Receipts from Loan from Statement of Cash Flows.
h. $5,000 Common Stock = $5,000 Com. Stock from Statement of Changes in Stockholders' Equity.
i. $100 Retained Earnings = $100 Ret. Earnings from Statement of Changes in Stockholders' Equity.
j. $5,100 Total Stockholders' Equity = $5,000 Common Stock + $100 Retained Earnings or $5,100 Total Stk. Equity from Statement of Changes in Stk. Equity.
k. $700 Cash Receipts from Revenue = $700 Revenue from Income Statement.
l. $500 Cash Payment for Expenses = $500 Expense from Income Statement.
m. $600 Net Income = $1,300 Revenue – $700 Expense.
n. $5,000 Beginning Common Stock = $5,000 Ending Common Stock Year 1.
o. $600 Net Income = $600 Net Income from Income Statement.
p. $200 Ending Retained Earnings = $100 Beginning Ret. Earnings + $600 Net Income – $500 Dividends.
q. $3,200 Cash = Ending Cash Balance from Statement of Cash Flows.
r. $8,000 Land = $8,000 Cash Payment for Land from Statement of Cash Flows.
s. $6,000 Common Stock = $6,000 Ending Common Stock from Statement of Changes in Equity.
t. $8,000 Ending Common Stock = $6,000 Beginning Common Stock + $2,000 Common Stock Issued.
u. $2,600 Cash = $2,600 Ending Cash Balance from Statement of Cash Flows.
v. $2,000 Cash Receipts from Revenue = $2,000 Revenue from Income Statement.
w. $1,300 Cash Payments for Expenses = $1,300 Expense from Income Statement.
x. $3,000 Cash Payment to Reduce Debt = $5,000 Balance of Liabilities, Year 2– $2,000 Balance of Liabilities, Year 3.
y. $2,000 Cash Receipts from Stock Issue = $2,000 Stock Issued from Statement of Changes in Stockholders' Equity.
z. $300 Cash Payment for Dividends = $300 Dividends from Statement of Changes in Stockholders' Equity

PROBLEM 2-43A

a.

Alcorn Service Company
Accounting Equation for Year 1

		Assets					=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	=	Accts. Pay.	Salaries Payable	Unearn. Rev.	+	Com. Stock	Ret. Earn.
1.	AS	20,000	NA	NA	NA	NA	=	NA	NA	NA	+	20,000	NA
2.	AS	NA	NA	800	NA	NA	=	800	NA	NA	+	NA	NA
3.	AE	(14,000)	NA	NA	NA	14,000	=	NA	NA	NA	+	NA	NA
4.	AU	(800)	NA	NA	NA	NA	=	(800)	NA	NA	+	NA	NA
5.	AS	NA	10,500	NA	NA	NA	=	NA	NA	NA	+	NA	10,500
6.	AU	(3,800)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(3,800)
7.	AE	7,000	(7,000)	NA	NA	NA	=	NA	NA	NA	+	NA	NA
8.	CE	NA	NA	NA	NA	NA	=	NA	3,600	NA	+	NA	(3,600)
9.	AU	NA	NA	(700)	NA	NA	=	NA	NA	NA	+	NA	(700)
Totals		8,400	3,500	100	-0-	14,000	=	-0-	3,600	-0-	+	20,000	2,400

PROBLEM 2-43A (cont.)

a.

Alcorn Service Company
Accounting Equation for Year 2

		Assets					=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	=	Accts. Pay.	Salaries Payable	Unearn Rev.	+	Com. Stock	Ret. Earn.
Bal.		8,400	3,500	100	-0-	14,000	=	-0-	3,600	-0-	+	20,000	2,400
1.	AS	15,000	NA	NA	NA	NA	=	NA	NA	NA	+	15,000	NA
2.	AU	(3,600)	NA	NA	NA	NA	=	NA	(3,600)	NA	+	NA	NA
3.	AE	(9,000)	NA	NA	9,000	NA	=	NA	NA	NA	+	NA	NA
4.	AE	14,000	NA	NA	NA	(14,000)	=	NA	NA	NA	+	NA	NA
5.	AS	6,000	NA	NA	NA	NA	=	NA	NA	6,000	+	NA	NA
6.	AS	NA	NA	2,400	NA	NA	=	2,400	NA	NA	+	NA	NA
7.	AS	NA	24,500	NA	NA	NA	=	NA	NA	NA	+	NA	24,500
8.	AE	12,600	(12,600)	NA	NA	NA	=	NA	NA	NA	+	NA	NA
9.	AU	(2,000)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(2,000)
10.	AU	(2,850)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(2,850)
11.	AU	NA	NA	NA	(7,500)[1]	NA	=	NA	NA	NA	+	NA	(7,500)
12.	CE	NA	NA	NA	NA	NA	=	NA	NA	(1,500)[2]	+	NA	1,500
13.	AU	NA	NA	(2,200)[3]	NA	NA	=	NA	NA	NA	+	NA	(2,200)
14.	CE	NA	NA	NA	NA	NA	=	NA	4,800	NA	+	NA	(4,800)
Totals		38,550	15,400	300	1,500	-0-	=	2,400	4,800	4,500	+	35,000	9,050

[1] \$9,000 x 10/12 = \$7,500
[2] \$6,000 x 3/12 = \$1,500
[3] \$100 + \$2,400 – \$300 = \$2,200

PROBLEM 2-43A (cont.)

b.

Alcorn Service Company Financial Statements For the Years Ended December 31, Year 1 and Year 2		
Income Statements		
	Year 1	Year 2
Service Revenue	$10,500	$26,000
Total Revenue	10,500	26,000
Expenses		
Operating Expenses	(3,800)	(2,850)
Supplies Expense	(700)	(2,200)
Salaries Expense	(3,600)	(4,800)
Rent Expense	-0-	(7,500)
Total Expenses	(8,100)	(17,350)
Net Income (Loss)	$2,400	$ 8,650
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$20,000
Plus: Stock Issued	20,000	15,000
Ending Common Stock	20,000	35,000
Beginning Retained Earnings	-0-	2,400
Plus/Less: Net Income (Loss)	2,400	8,650
Less: Dividends	-0-	(2,000)
Ending Retained Earnings	2,400	9,050
Total Stockholders' Equity	$22,400	$44,050

PROBLEM 2-43A (cont.)

b.

Alcorn Service Company Balance Sheets As of December 31, Year 1 and Year 2		
	Year 1	Year 2
Assets		
Cash	$ 8,400	$38,550
Accounts Receivable	3,500	15,400
Supplies	100	300
Prepaid Rent	-0-	1,500
Land	14,000	-0-
Total Assets	$26,000	$55,750
Liabilities		
Accounts Payable	$ -0-	$ 2,400
Salaries Payable	3,600	4,800
Unearned Revenue	-0-	4,500
Total Liabilities	3,600	11,700
Stockholders' Equity		
Common Stock	20,000	35,000
Retained Earnings	2,400	9,050
Total Stockholders' Equity	22,400	44,050
Total Liab. and Stock. Equity	$26,000	$55,750

PROBLEM 2-43A (cont.)

b.

Alcorn Service Company Statements of Cash Flows For the Years Ended December 31, Year 1 and Year 2		
	Year 1	Year 2
Cash Flows From Operating Activities:		
Cash Receipts from Customers[1]	$7,000	$18,600
Cash Payments for Expense[2]	(4,600)	(15,450)
Net Cash Flow from Operating Activities	2,400	3,150
Cash Flows From Investing Activities:		
Cash Payment for Land	(14,000)	-0-
Cash Proceeds from Sale of Land	-0-	14,000
Net Cash Flow From Investing Activities	(14,000)	14,000
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	20,000	15,000
Cash Payment for Dividends	-0-	(2,000)
Net Cash Flow From Financing Activities	20,000	13,000
Net Change in Cash	8,400	30,150
Plus: Beginning Cash Balance	-0-	8,400
Ending Cash Balance	$8,400	$38,550

[1]Year 2: $6,000 + $12,600 = $18,600

[2]Year 1: $3,800 + $800 = $4,600

Year 2: $3,600 + $9,000 + $2,850 = $15,450

PROBLEM 2-44A

The three common features of ethical misconduct are:

1. **The availability of an opportunity**
2. **The existence of some sort of pressure**
3. **The capacity for rationalization**

1. **Even though Pete has exceeded his authority, no one has complained because he is bringing in more revenue. Oversight by a partner would eliminate this type of problem.**

2. **Pete is in a financial bind and does not want to discuss his problem with others for fear of ruining his image. Therefore, he is willing to take risks to keep his secret.**

3. **He rationalizes that his actions do not hurt anyone because the client is getting the service and the firm is getting a reasonable fee.**

PROBLEM 2-45A (Appendix)

Accounting Equation (Prepared for Instructor's Use)

Accounting Equation														
	Assets							Liabilities					Stk. Equity	
Date	Cash	Acc Rec.	Pp. Rent	Supp.	Truck	Acc Depr.	Land	Acc. Pay.	Sal. Pay.	Note Pay.	Int Pay.	Unear. Rev.	Com. Stock	Ret. Earn
Bal.	26,000	9,000					42,000	5,000					28,000	44,000
1/1	15,000												15,000	
1/1	(22,000)				22,000									
2/1	12,000									12,000				
2/1	(3,000)		3,000											
3/1	(2,000)													(2,000)
4/1	(28,000)						28,000							
5/1	(4,000)							(4,000)						
7/1	5,400											5,400		
9/1	42,000						(42,000)							
10/1				5,000				5,000						
12/31		42,000												42,000
12/31	40,000	(40,000)												
12/31								6,000						(6,000)
12/31									5,200					(5,200)
12/31				(4,800)										(4,800)
12/31a						(5,000)[1]								(5,000)
12/31a											990[2]			(990)
12/31a			(2,750)[3]											(2,750)
12/31a												(2,700)[4]		2,700
Bal.	81,400	11,000	250	200	22,000	(5,000)	28,000	12,000	5,200	12,000	990	2,700	43,000	61,960

(1) 12/31a Depreciation Expense $22,000 – $2,000 = $20,000; $20,000 ÷ 4 = $5,000
(2) 12/31a Interest Expense $12,000 x 9% = $1,080; $1,080 x 11/12 = $990
(3) 12/31a Expired Rent $3,000 x 11/12 = $2,750
(4) 12/31a Unearned Revenue earned $5,400 x 6/12 = $2,700

PROBLEM 2-45A (cont.)

a. The four transactions that need adjusting entries are as follows:
   1. Jan. 1, purchase of truck; depreciation expense.
   2. Feb. 1, note payable issued; interest expense.
   3. Feb. 1, prepaid rent; rent expense.
   4. July 1, unearned revenue; cash was received in advance; earned revenue.

b. $12,000 x 9% x 11/12 = $990

c. $40,000 + $5,400 – $3,000 – $4,000 = $38,400

d. $3,000 x 11/12 = $2,750

e. $12,000 + $5,200 + $12,000 + $2,700 + 990 = $32,890

f. $5,000 – $200 = $4,800

g. $5,400 – $2,700 ($5,400 x 6/12) = $2,700

h. ($22,000) + ($28,000) + $42,000 + = ($8,000)

i. $12,000 x 9% x 11/12 = $990

j. Total expenses, $24,740 ($6,000 + $5,200 + $4,800 + $2,750 + $5,000 + $990)

k. Ending retained earnings $62,460 (Beg. RE $44,000 + NI $20,460 – Div. $2,000)

l. Service revenue $44,700 = $42,000 + $2,700

m. $25,000 = $12,000 + $15,000 – $2,000

n. $19,960 = (l) $44,700 – (j) $24,740

SOLUTIONS TO ANALYZE, THINK, COMMUNICATE – CHAPTER 2

ATC 2-1 (All dollar amounts are in millions.)

1. **Target's accrual accounts are: Accounts payable, Accrued and other current liabilities. The "Other current assets" accounts includes two "Vendor income receivables" and "Income tax and other receivables." See Note 13. As Note 18 shows, all of the individual accounts included in "Accrued and other current liabilities" are accrual accounts.**

   The "Deferred income taxes" account shown under Liabilities is probably best classified as an accrual account, but students will probably think it is a deferral account.

2. **Target's deferral accounts are: Inventories, Buildings and improvements, Fixtures and equipment, Computer hardware and software, and Construction in progress. Note 13 discloses that "Other current assets" includes Prepaid expenses.**

3. | | |
   |---|---|
   | **Net income for 2016 was** | **$2,737** |
   | **Cash provided by operating activities for 2016 was** | **$5,436** |

   Thus, cash flow from operating activities exceeded net income by $2,699.

4. **Net income decreased by $626 from 2015 to 2016 ($2,737 - $3,363). Cash provided by operating activities decreased by $522 from 2015 to 2016 ($5,436- $5,958). Therefore, the change in net earnings was the greatest.**

ATC 2-2

1. (in millions)

	2016	2015	2014
Revenue	$125,980	$131,620	$127,079
Less: Operating expenses	98,921	98,560	107,480
Operating income	$ 27,059	$ 33,060	$ 19,599

2. The balance in Retained earnings would be increased by Verizon's net earnings for each year.

3. Growth rates for operating income are:

2016: ($27,059 - $33,060) ÷ $33,060 = (18.2%)
2015: ($33,060 - $19,599) ÷ $19,599 = 68.7%
2014: ($19,599 - $31,968) ÷ $31,968 = (38.7%)

ATC 2-3

Dollar amounts are in thousands.

a.

	2015	2016
Revenues	$2,842,284	$2,912,351
- Expenses	2,678,381	2,723,052
Net income	$ 163,903	$ 189,299
Beg. retained earnings	$ 493,167	$ 485,687
+ Net income	163,903	189,299
- Dividends	171,383	186,505
End. Retained earnings	$ 485,687	$ 488,481

b. Revenue increased by 2.5%
($2,912,351 - $2,842,284) ÷ $2,842,284 = 2.5%

Net income increased by 15.5%
($189,299 - $163,903) ÷ $163,903 = 15.5%

c. 2015: $163,903 ÷ $2,842,284 = 5.8%
2016: $189,299 ÷ $2,912,351 = 6.5%

d. Both revenues and net income increased in 2016, and net income as a percentage of revenues was also higher in 2016, thus, 2016 appears to have been a better year than 2015.

ATC 2-4

Dollar amounts in thousands.

a. & b.

	2015	2016
Cash from operating activities	$ 237,260	$ 282,589
Cash from investing activities	(365,191)	(144,844)
Cash from financing activities	45,499	(99,666)
Net change in cash	(82,432)	38,079
+ Beg. cash balance	93,329	10,897
= End. Cash balance	$ 10,897	$ 48,976

c. Negative cash flow from investing activities is most likely an indication that the company is growing, which is not a negative situation.

Note to instructor: The ending cash balances shown above will not match exactly with those on the company's balance sheet due to small adjustments for "exchange rate adjustments." These were omitted to simplify this problem.

ATC 2-5

Dollar amounts are in thousands.

a.

	Abercrombie & Fitch	American Eagle Outfitters
Revenues	$ 3,518,680	$ 3,521,848
Expenses	3,483,104	3,303,710
Net income	$ 35,576	$ 218,138
Beg. retained earnings	$2,550,673	$ 1,543,085
+ Net income	35,576	218,138
- Dividends	(55,145)	(99,624)
End. Retained earnings	$2,531,104	$1,661,599

b. **Abercrombie: $ 35,576 ÷ $3,518,680 = 1.0%**
American Eagle: $ 218,138 ÷ $3,521,848 = 6.2%

c. **American Eagle had higher net income in absolute dollars and higher income as a percentage of revenue than Abercrombie. Therefore, based on this information alone, it might be argued that American Eagle had the better performance in its 2016 fiscal years.**

Note to Instructor:

The balances in retained earnings reported above are not the same as the amounts that appear in the companies' annual reports because the companies had deductions from retained earnings other than dividends, such as share-based compensation charges. These topics are beyond the material in this chapter, so they are not presented.

ATC 2-6

Dollar amounts in thousands.

a. & b.

	H&R Block	Intuit
Revenues	$ 3,038,153	$ 4,694,000
Expenses	2,663,886	3,715,000
Net income	$ 374,267	$ 979,000
Cash from operating activities	$ 532,394	$ 1,401,000
Cash from investing activities	329,515	371,000
Cash from financing activities	(1,961,729)	(1,940,000)
Net change in cash	(1,099,820)	(168,000)
+ Beg. cash balance	2,007,190	808,000
= End. Cash balance	$ 907,370	$ 640,000

c. **A company that is growing often has negative cash flows from investing activities because it is buying significant amounts of long-term assets in order to expand its capacity. However, when cash flow from investing activities is positive, it can be the result of a shrinking company, which is negative. Or, it could be the result of the company disposing of unneeded financial assets, such as investment securities. This would not necessarily be negative. Though not evident from the data presented, H&R's revenue and net earnings have been declining in recent years due to more individuals using software, such as Turbo Tax, to prepare their tax returns versus going to tax preparations services such as H&R Block.**

d. **Negative cash flows from financing activities is not as common as are negative cash flows from investing activities. However, negative cash flow from financing activities is usually the result of the company paying off some of its debt, which is not a negative situation. It can also result from the company buying back its own stock, but students are unlikely to think of this as a cause.**

ATC 2-6 (cont.)

Note to instructor: The ending cash balances shown above for H&R Block will not match exactly with those on the company's balance sheet due to small adjustments for "exchange rate adjustments." These were omitted to simplify this problem.

ATC 2-7

a.

Income Statement		Balance Sheet	
Service Revenue	$120,000	Assets:	$167,000
Operating Exp.	(40,000)		
Net Income	$ 80,000	Liabilities:	$ 5,000
		Stockholders' Equity:	
		Common Stock	82,000
		Retained Earnings	80,000
		Total Liab.	162,000
		Total Liab. and Stk. Equity	$167,000

Computations for Income Statement Items:

Revenue: $38,000+$82,000 = $120,000
Operating Expense: $70,000 – $30,000 = $40,000

Computations for Balance Sheet Items:

Assets: $85,000+$82,000 = $167,000
Liabilities: $35,000 – $30,000 = $5,000
Retained Earnings: ($32,000) + $82,000 + $30,000 = $80,000

b. **Willful deception is an act of fraud and punishable under the law. Good intentions are not sufficient justification for breaking the law. Students should learn to avoid operating under an ends justifies the means philosophy. Suppose the unexpected happens in this case. Glenn fails to obtain the contract and is forced to declare bankruptcy after having manipulated the statements. He would not only stand to lose the friend that he deceived, but also may be convicted of a felony on charges of**

fraudulent reporting.

ACT 2-7 (cont.)

c. **The auditing profession has identified three elements that are typically present when fraud occurs. They are: (1) the availability of an opportunity, (2) the existence of some form of pressure leading to an incentive, and (3) the capacity for rationalization. Glenn had the opportunity to record the questionable adjustments because he was the owner and could make whatever adjustments he deemed appropriate. Glenn's existence of pressure is the fact that he needs the financial statements to look good in order to obtain the loan. Because Glenn was confident that the contracts would be approved, he was able to rationalize making the adjustments. All three of the factors of ethical misconduct are present in this case.**

ATC 2-8

This solution is based on Netflix's 2016 financial report.

a. Netflix's accrual accounts are:

Current content liabilities (though students will probably not list this account)
Accounts payable
Accrued expenses

b. Netflix's deferral accounts are:

Content library, net (short-term and long-term) {shown under assets]
Property, plant and equipment, net
Other current assets
Other noncurrent assets (possibly, depending on the nature of the asset)
Deferred revenues

SOLUTIONS TO EXERCISES - SERIES B - CHAPTER 2

EXERCISE 2-1B

Smith Company
Effect of Events on the Year 1 Accounting Equation

	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue	NA	+	12,000	=	NA	+	NA	+	12,000
Coll. Acct. Rec.	9,800	+	(9,800)	=	NA	+	NA	+	
Ending Balance	9,800	+	2,200	=	-0-	+	-0-	+	12,000

a. Accounts Receivable: $12,000 – $9,800 = $2,200

b. $12,000

c. $9,800 cash collected from accounts receivable.

d. $12,000

e. $12,000 of revenue was earned but only $9,800 of it was collected.

EXERCISE 2-2B

a.

Star Corporation Accounting Equation - Year 1								
Event	Assets	=	Liabilities	+	Stockholders' Equity			
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.	5,000	=	NA	+	NA	+	5,000
Accrued Sal.	NA	=	3,000	+	NA	+	(3,000)
Ending Bal.	5,000	=	3,000	+	-0-	+	2,000

Star Corporation Balance Sheet As of December 31, Year 1		
Assets		
Cash	$5,000	
Total Assets		$5,000
Liabilities		
Salaries Payable	$3,000	
Total Liabilities		$3,000
Stockholders' Equity		
Retained Earnings	$2,000	
Total Stockholders' Equity		2,000
Total Liab. and Stockholders' Equity		$5,000

b.

Computation of Net Income	
Revenue	$5,000
Less: Expenses	(3,000)
Net Income	$2,000

EXERCISE 2-2B (cont.)

c.

Cash Flow from Operating Activities	
Cash from Revenue	**$5,000**
Net Cash Flow from Operating Act.	**$5,000**

d. **The salary expense is deducted from revenue in computing net income, but it has not been paid. This creates a difference of $3,000. The revenue is the same because it has been earned and collected.**

EXERCISE 2-3B

a.

Talley Inc.
General Ledger Accounts for the Year Ended December 31, Year 1

	Assets		=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accts. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earnings	Acct. Title for RE
1.	20,000	NA	=	NA	+	20,000	NA	
2.	NA	38,000	=	NA	+	NA	38,000	Revenue
3.	(2,500)	NA	=	NA	+	NA	(2,500)	Util. Exp.
4.	21,000	(21,000)	=	NA	+	NA	NA	
5.	NA	NA	=	15,000	+	NA	(15,000)	Sal. Exp.
6.	(2,000)	NA	=	NA	+	NA	(2,000)	Dividends
Totals	36,500	17,000	=	15,000	+	20,000	18,500	

b.

Talley Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue		$38,000
Expenses		
Utilities Expense	$ 2,500	
Salaries Expense	15,000	
Total Expenses		(17,500)
Net Income		$20,500

EXERCISE 2-3B (cont.)

b.

Talley Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	20,000	
Ending Common Stock		$20,000
Beginning Retained Earnings	$ -0-	
Plus: Net Income	20,500	
Less: Dividends	(2,000)	
Ending Retained Earnings		18,500
Total Stockholders' Equity		$38,500

Talley Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$36,500	
Accounts Receivable	17,000	
Total Assets		$53,500
Liabilities		
Salaries Payable	$15,000	
Total Liabilities		$15,000
Stockholders' Equity		
Common Stock	$20,000	
Retained Earnings	18,500	
Total Stockholders' Equity		38,500
Total Liab. and Stockholders' Equity		$53,500

EXERCISE 2-3B (cont.)

b.

Talley Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flow From Operating Activities		
Cash Receipts from Customers	**$21,000**	
Cash Paid for Expenses	**(2,500)**	
Net Cash Flow from Operating Act.		**$18,500**
Cash Flow From Investing Activities		**-0-**
Cash Flow From Financing Activities		
Issue of Stock	**$20,000**	
Paid Dividends	**(2,000)**	
Net Cash Flow from Financing Act.		**18,000**
Net Change in Cash		**36,500**
Plus: Beginning Cash Balance		**-0-**
Ending Cash Balance		**$36,500**

c. Net income is based on income earned of $38,000 and expenses incurred of $17,500 for a net income of $20,500. Net cash flow from operating activities is based on cash collected from revenue, $21,000 and expenses paid, $2,500, for a net cash flow from operating activities of $18,500. The difference of $2,000 is reflected in the Accounts Receivable account ($17,000), revenues accrued but not yet collected, and the Salaries Payable account ($15,000), expenses incurred but not paid.

EXERCISE 2-4B

a.

Parker and Moates
Statements Model
Year 1

Event	Balance Sheet									Income Statement					Statement of
	Assets			=	Liabilities			+	Stk. Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flows
	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earnings						
1.	NA	+	96,000	=	NA	+	NA	+	96,000	96,000	–	NA	=	96,000	NA
2.	65,000	+	NA	=	NA	+	NA	+	65,000	65,000	–	NA	=	65,000	65,000 OA
3.	NA	+	NA	=	45,000	+	NA	+	(45,000)	NA	–	45,000	=	(45,000)	NA
4.	(26,000)	+	NA	=	NA	+	NA	+	(26,000)	NA	–	26,000	=	(26,000)	(26,000) OA
5.	70,000	+	(70,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	70,000 OA
6.	(38,000)	+	NA	=	(38,000)	+	NA	+	NA	NA	–	NA	=	NA	(38,000) OA
7.	(10,000)	+	NA	=	NA	+	NA	+	(10,000)	NA	–	NA	=	NA	(10,000) FA
8.	NA	+	NA	=	NA	+	3,000	+	(3,000)	NA	–	3,000	=	(3,000)	NA
Totals	61,000	+	26,000	=	7,000	+	3,000	+	77,000	161,000	–	74,000	=	87,000	61,000 NC

b. Total assets: $87,000 ($61,000 + $26,000)

c. $26,000

d. $7,000

e. Accounts Receivable (an asset) is an amount owed to Parker and Moates: $26,000; Accounts Payable (a liability) is an amount that Parker and Moates owes: $7,000.

f. $87,000

g. $71,000 ($65,000 – $26,000 + $70,000 – $38,000)

EXERCISE 2-5B

a.

Computation of Net Income	
Revenue recognized on account	$40,000
Less accrued salary expense	(35,000)
Net Income	$ 5,000

b.

Computation of Cash Collected from Accounts Receivable	
Beginning balance of Accounts Receivable	$ 2,000
Add revenue recognized on account	40,000
Less ending balance of Accounts Receivable	(2,400)
Cash collected from accounts receivable	$39,600

Computation of Cash Paid for Salaries Expense	
Beginning balance of Salaries Payable	$ 1,300
Add accrued salary expense recognized	35,000
Less ending balance of Salaries Payable	(900)
Cash paid for salary expense	$35,400

Cash Flow from Operating Activities	
Cash from accounts receivable	$39,600
Cash paid for salary expense	(35,400)
Net Cash Flow from Operating Act.	$ 4,200

EXERCISE 2-6B

a. & c.

Event	Revenue	Expense	Statement of Cash Flows
1.	NA	NA	$50,000 FA
2.	$67,000	NA	NA
3.	NA	NA	(5,000) FA
4.	NA	NA	45,000 OA
5.	NA	$49,000	(49,000) OA
6.	10,000	NA	10,000 OA
7.	NA	2,000	NA

b.

Computation of Net Income	
Revenue	$77,000
Less: Expenses	(51,000)
Net Income	$26,000

d.

Cash Flow from Operating Activities	
Cash from Revenue	$55,000
Cash paid for expenses	(49,000)
Net Cash Flow from Operating Act.	$ 6,000

e. The before-closing balance in the Revenue account is $77,000. After it is closed to Retained Earnings the balance will be zero. Other accounts that would be closed are expenses and dividends.

f. The balance of Retained Earnings on the Year 1 Balance Sheet will be the amount of Net Income: $26,000, less $5,000 of dividends paid since there is no beginning balance in Retained Earnings.

EXERCISE 2-7B

Hall Inc. Effect of Events on the General Ledger Accounts										
	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings
1. Sales on Account	NA	72,000	NA	=	NA	+	NA	+	72,000
2. Coll. Accts. Rec.	55,000	(55,000)	NA	=	NA	+	NA	+	NA
3. Incurred Expense	NA	NA	NA	=	42,000	+	NA	+	(42,000)
4. Pd. Acc. Pay.	(34,000)	NA	NA	=	(34,000)	+	NA	+	NA
5. Issue of Stock	44,000	NA	NA	=	NA	+	44,000	+	NA
6. Purchase Land	(18,000)	NA	18,000	=	NA	+	NA	+	NA
Totals	47,000	17,000	18,000	=	8,000	+	44,000	+	30,000

a. Revenue recognized, $72,000.

b. Cash flow from revenue, $55,000.

c. Revenue, $72,000, less operating expenses, $42,000 = $30,000 net income.

d. Accounts receivable collected, $55,000, less cash paid for expenses, $34,000 = $21,000 cash flow from operating activities.

e. Income of $72,000 was earned, but only $55,000 was collected (a difference of $17,000); operating expenses incurred were $42,000 but only $34,000 was paid during the period (a difference of $8,000). Consequently, net income is $9,000 more than cash flow from operating activities.

f. $18,000 cash outflow for the purchase of land.

g. $44,000 cash inflow from the issue of common stock.

h. Total assets = $82,000 ($47,000 + $17,000 + $18,000)
Total liabilities = $8,000
Total equity = $74,000 ($44,000 + $30,000)

EXERCISE 2-8B

a. Retained Earnings is a permanent account, meaning that one period's ending balance becomes the next period's beginning balance. Since the December 31, Year 2 after-closing balance is $19,400, this will also be the balance on January 1, Year 3.

b. The temporary accounts (Revenue, Expense, and Dividends) are closed at the end of each accounting cycle. As a result, they will always have a zero balance at the beginning of each accounting period.

c. The December 31, Year 1 balance in the Retained Earnings account is the same balance as the January 1, Year 2 balance, computed as follows:

Beginning Retained Earnings Balance, January 1, Year 2	$?
+ Net Income (Revenue $15,100 – Expenses 9,200)	5,900
– Dividends	(1,500)
= Ending Retained Earnings Balance, December 31, Year 2	$19,400

Working backwards:
End. Retained Earnings + Dividends – Net Income = Beg. Retained Earnings; and January 1, Year 2 = December 31, Year 1 = $19,400 + $1,500 – $5,900 = $15,000 = January 1, Year 2 Retained Earnings
Therefore:
December 31, Year 1 Retained Earnings = $15,000

d. The revenue and expense data are recorded in Revenue and Expense accounts and do not affect retained earnings at the time of recognition. The balance in the Retained Earnings account on June 30, Year 2 is the same as it was on January 1, Year 2 which is $15,000.

EXERCISE 2-9B

a.

Permanent Accounts
Cash
Notes Payable
Land
Common Stock
Retained Earnings

Temporary (Nominal) Accounts
Revenue
Expenses
Dividends

b.

Beginning Retained Earnings	$5,200
Add: Revenue	7,000
Less: Expenses	(4,200)
Less: Dividends	(1,000)
Ending Retained Earnings	$7,000

c.

Computation of Net Income	
Revenue	$7,000
Less: Expenses	(4,200)
Net Income	$2,800

d. Net income is only the current year's net income. Retained Earnings is an accumulation of net income over the life of the business less any dividends that have been paid over the years.

e. All revenue, expense and dividends accounts will have a zero balance because they have been closed to retained earnings.

EXERCISE 2-10B

a.

Account	Classification
1. Service Revenue	T
2. Dividends	T
3. Common Stock	P
4. Notes Payable	P
5. Cash	P
6. Rent Expense	T
7. Accounts Receivable	P
8. Utilities Expense	T
9. Prepaid Insurance	P
10. Retained Earnings	P

b. The accounting cycle is divided into one-year accounting periods. Using the accounting cycle rationale, experience is gained one year at a time. But experience is like the balance sheet; it accumulates and one year adds to another. You do not start over at the beginning of each year when working at the same job.

EXERCISE 2-11B

a. Directly matched

b. Period expense

c. Period expense

d. Directly matched

EXERCISE 2-12B

a.

Handy Andy Inc. Effect of Events on Financial Statements for Year 2																
	Assets			=	Liab.	+	Stockholders' Equity			Income Statement					Statement of Cash Flows
Event	Cash	+	Supplies	=	Accts. Pay.	+	Com. Stock	+	Retained Earnings	Rev.	–	Exp.	=	Net Income	
Beg.	9,000	+	-0-	=	-0-	+	5,000	+	4,000	-0-	–	-0-	=	-0-	-0-
1.	NA	+	9,500	=	9,500	+	NA	+	NA	NA	–	NA	=	NA	NA
2.	32,500	+	NA	=	NA	+	NA	+	32,500	32,500	–	NA	=	32,500	32,500 OA
3.	(7,200)	+	NA	=	(7,200)	+	NA	+	NA	NA	–	NA	=	NA	(7,200) OA
4.	NA	+	(7,800)	=	NA	+	NA	+	(7,800)	NA	–	7,800	=	(7,800)	NA
Totals	34,300	+	1,700	=	2,300	+	5,000	+	28,700	32,500	–	7,800	=	24,700	25,300 NC

b. The difference in net income and cash flow from operating activities of $600 ($24,700 – $25,300) is attributed to recognizing supplies expense of $7,800 in the income statement, whereas the cash payment on accounts payable (for supplies) was $7,200.

EXERCISE 2-13B

a.

Janitorial Professionals Inc. Effect of Events on the Accounting Equation						
	Assets		=	Liab.	+	Stk. Equity
Event	Cash	Supplies	=	Accounts Payable	+	Retained Earnings
1. Provided Service	20,000	NA	=	NA	+	20,000
2. Purchased Supplies	NA	4,000	=	4,000	+	NA
3. Used Supplies	NA	(3,000)	=	NA	+	(3,000)
Totals	20,000	1,000	=	4,000	+	17,000

b.

Janitorial Professionals Inc. Income Statement For the Year Ended December 31, Year 1	
Revenue	$20,000
Expense	(3,000)
Net Income	$17,000

Janitorial Professionals Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$20,000	
Supplies	1,000	
Total Assets		$21,000
Liabilities		
Accounts Payable	$ 4,000	
Total Liabilities		$ 4,000
Stockholders' Equity		
Retained Earnings	$17,000	
Total Stockholders' Equity		17,000
Total Liab. and Stockholders' Equity		$21,000

EXERCISE 2-13B (cont.)

b.

Janitorial Professionals Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$20,000	
Net Cash Flow from Operating Activities		$20,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		20,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$20,000

c. The balance of the Supplies account on January 1, Year 2 is $1,000, the same as the December 31, Year 1 balance.

d. The balance of the Supplies Expense account on January 1, Year 2 is zero because the expense account was closed to Retained Earnings at December 31, Year 1.

EXERCISE 2-14B

a. A <u>cost</u> that is an asset is the cost of resources that are given up in acquiring some type of asset, such as an automobile, office equipment, or land. A <u>cost</u> that is an expense is the use of assets (depreciation) or the payment for an expense that is incurred in the current period (utilities, salaries, etc.).

b. Examples of costs that are assets:
   1. Purchased land
   2. Purchased equipment
   3. Purchased supplies for future use.

c. Examples of costs that are expenses:
   1. Paid monthly salary expense.
   2. Paid monthly utilities expense.
   3. Used supplies that had been previously purchased.

EXERCISE 2-15B

a.

Forestry Services Inc. Effect of Events on the Accounting Equation				
	Assets		=	Stockholders' Equity
Event	Cash	Prepaid Rent	=	Retained Earnings
1. Performed Services	18,000	NA	=	18,000
2. Prepaid Rent	(12,000)	12,000	=	NA
3. Used Rent	NA	(11,000)*	=	(11,000)
Totals	6,000	1,000	=	7,000

*$12,000 x 11/12 = $11,000

b.

Forestry Services Inc. Income Statement For the Year Ended December 31, Year 1	
Revenue	$18,000
Expense	(11,000)
Net Income	$ 7,000

Forestry Services Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$6,000	
Prepaid Rent	1,000	
Total Assets		$7,000
Liabilities		$ -0-
Stockholders' Equity		
Retained Earnings	$7,000	
Total Stockholders' Equity		7,000
Total Liab. and Stockholders' Equity		$7,000

EXERCISE 2-15B (cont.)

b.

Forestry Services Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$18,000	
Cash Payment for Rent	(12,000)	
Net Cash Flow from Operating Activities		$6,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		6,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$6,000

c. The balance of the Prepaid Rent will be expensed in Year 2, $1,000.

EXERCISE 2-16B

a.

Ark Corporation Accounting Equation Year 1						
	Assets		=	Stockholders' Equity		
Event	Cash	Prepaid Insurance	=	Com. Stock	+	Retained Earnings
Pur. Insurance	(8,400)	8,400	=	NA	+	NA
Adj. Ins Exp.	NA	(2,450)*	=	NA	+	(2,450)
Totals	(8,400)	5,950	=	-0-	+	(2,450)

*$8,400 x 7/24 = $2,450

b. The required entry would decrease assets by $2,450 [($8,400 ÷ 24) x 7] and decrease stockholders' equity by $2,450 (retained earnings). If this entry is not made, assets and stockholders' equity would both be overstated on the balance sheet by $2,450. On the income statement, expenses would be understated causing net income to be overstated by $2,450.

EXERCISE 2-17B

a.

Interior Design Consultants Year 1					
Event	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Unearned Revenue	+	Retained Earnings
Coll. Unearned rev	24,000	=	24,000	+	NA
Recog. revenue earned	NA	=	(6,000)*	+	6,000
	24,000	=	18,000	+	6,000

*$24,000 x 3/12 = $6,000

b.

Interior Design Consultants Income Statement For the Year Ended December 31, Year 1	
Revenue	$6,000
Expense	-0-
Net Income	$6,000

Interior Design Consultants Balance Sheet As of December 31, Year 1		
Assets		
Cash	$24,000	
Total Assets		$24,000
Liabilities		-0-
Unearned Revenue	$18,000	
Total Liabilities		$18,000
Stockholders' Equity		
Retained Earnings	$ 6,000	
Total Stockholders' Equity		6,000
Total Liab. and Stockholders' Equity		$24,000

EXERCISE 2-17B (cont.)

b.

Interior Design Consultants Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$24,000	
Net Cash Flow from Operating Activities		$24,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		24,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$24,000

c. Nine months of unearned revenue from Year 1 will be recognized in Year 2:
$24,000 x 9/12 = $18,000

EXERCISE 2-18B

Note: This exercise can be used to assess writing skills.

The tutoring fees of $800 received in advance by Jake Lewis from Laura Dalton should be reported as a liability. Although Jake Lewis has received the cash, it has not yet been earned. Lewis has an obligation to either perform the services or refund the cash advance. When the tutoring service is provided to Laura, the unearned revenue should be recognized as revenue earned by Lewis.

EXERCISE 2-19B

Warren Attorney At Law
Effect of Transactions on the Financial Statements for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liabilities			+	S. Equity	Rev.	–	Exp.	=	Net Inc.	
Event	Cash	+	Supplies	=	Acct. Payable	+	Unearn. Revenue	+	Retained Earnings						
1.	NA	+	1,500	=	1,500	+	NA	+	NA	NA	–	NA	=	NA	NA
2.	36,000	+	NA	=	NA	+	36,000	+	NA	NA	–	NA	=	NA	36,000 OA
3.	84,000	+	NA	=	NA	+	NA	+	84,000	84,000	–	NA	=	84,000	84,000 OA
4.	(32,000)	+	NA	=	NA	+	NA	+	(32,000)	NA	–	32,000	=	(32,000)	(32,000) OA
5.	(8,000)	+	NA	=	NA	+	NA	+	(8,000)	NA	–	NA	=	NA	(8,000) FA
6.	(1,200)	+	NA	=	(1,200)	+	NA	+	NA	NA	–	NA	=	NA	(1,200) OA
7.	NA	+	(1,350)	=	NA	+	NA	+	(1,350)	NA	–	1,350	=	(1,350)	NA
8.	NA	+	NA	=	NA	+	(33,000)*	+	33,000	33,000	–	NA	=	33,000	NA
Totals	78,800	+	150	=	300	+	3,000	+	75,650	117,000	–	33,350	=	83,650	78,800 NC

*$36,000 x 11/12 = $33,000

EXERCISE 2-20B

a.

Brandon Baily Personal Financial Planning Horizontal Statements Model for Year 1												
	Assets	=	Liabilities	+	Stk. Equity	Income Statement						Statement of Cash Flows
Event	Cash	=	Unearned Revenue	+	Retained Earnings	Rev.	–	Exp.	=	Net Income		
1. Advance Payment	120,000	=	120,000	+	NA	NA	–	NA	=	NA		120,000 OA
2. Revenue Earned	NA	=	(80,000)*	+	80,000	80,000	–	NA	=	80,000		NA
Totals	120,000	=	40,000	+	80,000	80,000	–	-0-	=	80,000		120,000 NC

*$120,000 x 8/12 = $80,000

b. Revenue that will be recognized in Year 2 is $40,000, the remainder of the Year 1 unearned revenue.

c. $-0-, no cash is received. All cash was received in Year 1.

EXERCISE 2-21B

a.

Stokes Company Accounting Equation - Year 1								
Event	Assets		=	Liab.	+	Stockholders' Equity		
	Cash	Prepaid Rent	=		+	Common Stock	+	Retained Earnings
Paid 12 months rent	(4,800)	4,800	=	NA	+	NA	+	NA
Adj. for 3 months used	NA	(1,200)*	=	NA	+	NA	+	(1,200)

*$4,800 x 3/12 = $1,200

b.

Eastport Rentals Accounting Equation - Year 1							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Unearned Revenue	+	Common Stock	+	Retained Earnings
Recd. 12 months rent	4,800	=	4,800	+	NA	+	NA
Earned 3 months rent	NA	=	(1,200)*	+	NA	+	1,200

*$4,800 x 3/12 = $1,200

EXERCISE 2-22B

a. accrual

b. accrual

c. neither

d. deferral

e. neither

f. accrual

g. neither

h. deferral

i. neither

j. deferral

k. accrual

EXERCISE 2-23B

Note: There are many examples of events that illustrate the required effects. An example is given of each event.

a. Recognized revenue on account. The asset increased is either Cash or Accounts Receivable.

b. Recognized revenue where the cash had been received in advance. The liability decreased is Unearned Revenue

c. Recognized an expense on account. The liability account that increases includes the word "Payable" or "Accrued" in the title.

d. Paid monthly rent expense. The asset decreased is Cash. Other examples would include a transaction that causes a decrease to an asset account that includes the word "Prepaid" or a long-lived asset that is depreciated or amortized.

EXERCISE 2-24B

a.

Event	Requires year-end adjusting entry?
1.	No
2.	Yes
3.	No
4.	Yes
5.	No
6.	No
7.	No
8.	No
9.	Yes
10.	No

b. Adjusting entries are recorded before closing entries. Adjusting entries are required to update the accounts so that the correct amounts of income and expenses are recognized. After the adjusting entries have been made, the adjusted balances of the revenue and expense accounts are closed to retained earnings.

EXERCISE 2-25B

a.

Event	Classification
1.	FA
2.	OA
3.	OA
4.	NA
5.	OA
6.	NA
7.	NA
8.	OA
9.	FA
10.	OA

b.

Blair Company
Statement of Cash Flows
For the Year Ended December 31, Year 1

Cash Flows From Operating Activities:		
Cash from the collection of accts. rec.	$51,000	
Cash from service revenue	12,000	
Cash from svc. to be performed in future	21,000	
Cash payment on accounts payable	(22,000)	
Cash payment for rent	(7,200)	
Net Cash Flow from Operating Activities		$54,800
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		
Cash receipt from stock issue	$30,000	
Cash payment for dividends	(5,000)	
Net Cash Flow from Financing Activities		25,000
Net Change in Cash		$79,800
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$79,800

EXERCISE 2-26B

Item/Account	Statement		Item/Account	Statement
a. Consulting Revenue	IS		u. Rent Expense	IS
b. Market Value of Land	NA		v. Utilities Expense	IS
c. Supplies Expense	IS		w. Total Stockholders' Equity	BS/SE
d. Salaries Payable	BS		x. Unearned Revenue	BS
e. Notes Payable	BS		y. Cash Flow from Investing Activities	CF
f. Ending Common Stock	SE/BS		z. Insurance Expense	IS
g. Beginning Cash Balance	CF		aa. End. Retained Earn.	BS/SE
h. Prepaid Rent	BS		bb. Interest Revenue	IS
i. Net Change in Cash	CF		cc. Supplies	BS
j. Land	BS		dd. Beg. Retained Earn.	SE
k. Operating Expenses	IS		ee. Utilities Payable	BS
l. Total Liabilities	BS		ff. Cash Flow from Financing Activities	CF
m. "As of" Date Notation	BS		gg. Accounts Receivable	BS
n. Salaries Expense	IS		hh. Prepaid Insurance	BS
o. Net Income	IS/SE		ii. Ending Cash Balance	BS/CF
p. Service Revenue	IS		jj. Utilities Expense	IS
q. Cash Flow from Operating Activities	CF		kk. Accounts Payable	BS
r. Operating Income	IS		ll. Beg. Common Stock	SE
s. Interest Receivable	BS		mm. Dividends	SE/CF
t. Interest Revenue	IS		nn. Total Assets	BS

EXERCISE 2-27B

	Net Income		Cash Flow from Operating Activities	
Event	Direction of Change	Amount of Change	Direction of Change	Amount of Change
a.	NA	NA	NA	NA
b.	Increase	$20,000	Increase	$15,000
c.	Decrease	1,200[1]	Decrease	4,800
d.	Increase	5,000[2]	Increase	12,000
e.	Decrease	5,000	NA	NA
f.	NA	NA	NA	NA
g.	Increase	9,200	Increase	9,200
h.	Decrease	1,200[3]	Decrease	1,500
i.	Decrease	2,200	Decrease	2,200

[1]$4,800 x 3/12 = $1,200
[2]$12,000 x 5/12 = $5,000
[3]$2,000 – $800 = $1,200

EXERCISE 2-28B

Note: These are only sample transactions. Other similar transactions will satisfy the requirements of this exercise.

a. **The business invested cash by purchasing a building.**

   Collected accounts receivable.

b. **Purchased land with a note (liability).**

   Purchased supplies on account.

c. **Paid accounts payable.**

   Paid notes payable.

d. **Paid a cash dividend to owners.**

   Paid an expense with cash.

e. **Recorded accrued salaries.**

   Recorded the liability for the utility bill received, but not due until the next period.

f. **The business issued common stock to its owners.**

   Cash revenue is earned.

g. **Unearned revenue is earned and recognized.**

EXERCISE 2-29B

a. Asset Source

b. Asset Use

c. Asset Source

d. Claims Exchange

e. Asset Source

f. Asset Use

g. Asset Exchange

h. Asset Use

i. Asset Source

j. Asset Exchange

EXERCISE 2-30B

Note: These are only sample transactions. Other similar transactions will satisfy the requirements of this exercise.

a. Payment of rent expense; payment of other operating expense.

b. Payment of accounts payable; payment of dividends.

c. Received a note receivable in exchange for the sale of a delivery van.

d. Collection of accounts receivable; purchase of land.

e. Proceeds of a loan; issue of common stock.

EXERCISE 2-31B

Horizontal Statement Model															
						Stk. Equity			Income Statement					Statement of	
	Type of					Com.		Ret.					Net	Cash	
Event	Event	Assets	=	Liab.	+	Stock	+	Earn.	Rev.	–	Exp.	=	Inc.	Flows	
a.	AE	I/D		NA		NA		NA	NA		NA		NA	D	IA
b.	AS	I		NA		I		NA	NA		NA		NA	I	FA
c.	AE	I/D		NA		NA		NA	NA		NA		NA	I	OA
d.	AU	D		NA		NA		D	NA		I		D	D	OA
e.	CE	NA		I		NA		D	NA		I		D	NA	
f.	AS	I		I		NA		NA	NA		NA		NA	NA	
g.	AS	I		NA		NA		I	I		NA		I	NA	
h.	AE	I/D		NA		NA		NA	NA		NA		NA	D	OA
i.	AU	D		NA		NA		D	NA		I		D	NA	
j.	AS	I		NA		NA		I	I		NA		I	I	OA
k.	AU	D		D		NA		NA	NA		NA		NA	D	OA
l.	AU	D		NA		NA		D	NA		NA		NA	D	FA
m.	AU	D		NA		NA		D	NA		I		D	NA	
n.	CE	NA		I		NA		D	NA		I		D	NA	
o.	AU	D		D		NA		NA	NA		NA		NA	D	OA
p.	AS	I		I		NA		NA	NA		NA		NA	I	OA
q.	AS	I		NA		NA		I	I		NA		I	NA	

EXERCISE 2-32B

One provision of the Sarbanes-Oxley Act of 2002 clarifies the legal responsibility of company management, including the CFO and controller. This provision states that the company chief executive officer (CEO) and the chief financial officer (CFO) must certify in writing that they have reviewed the financial reports being issued, and that the reports present fairly the company's financial status. This provision would apply to the CEO and CFO of Hewlett-Packard Company. CEOs and CFOs who make intentional misrepresentations are subject to a fine of up to $5 million and imprisonment of up to 20 years.

EXERCISE 2-33B (Appendix)

a.

Highland Grill Accounting Equation for Year 1							
	Assets			=	Stockholders' Equity		
Event	Cash	Stove	Accum. Depr.	=	Com. Stock	+	Retained Earnings
1. Acq. Cap.	40,000	NA	NA	=	40,000	+	NA
2. Pur. Stove	(24,000)	24,000	NA	=	NA	+	NA
3. Rev.	21,000	NA	NA	=	NA	+	21,000
4. Paid Exp.	(3,500)	NA	NA	=	NA	+	(3,500)
5. Depr. Exp.	NA	NA	(5,000)*	=	NA	+	(5,000)
Totals	33,500	24,000	(5,000)	=	40,000	+	12,500

*(24,000 – $4,000) ÷ 4 = $5,000 depreciation per year

b.

Highland Grill Balance Sheet As of December 31, Year 1		
Assets		
Cash		$33,500
Stove	$24,000	
Less: Accum. Depreciation	(5,000)	19,000
Total Assets		$52,500
Liabilities		$ -0-
Stockholders' Equity		
Common Stock	$40,000	
Retained Earnings	12,500	
Total Stockholders' Equity		52,500
Total Liab. and Stockholders' Equity		$52,500

EXERCISE 2-33B (Appendix) (cont.)

b.

Highland Grill **Statement of Cash Flows** **For the Year Ended December 31, Year 1**		
Cash Flows From Operating Activities:		
Cash Receipts from Revenue	**$21,000**	
Cash Payment for Salaries	**(3,500)**	
Net Cash Flow from Operating Activities		**$17,500**
Cash Flows From Investing Activities:		
Cash Outflow for Stove	**(24,000)**	
Net Cash Flow from Investing Activities		**(24,000)**
Cash Flows From Financing Activities:		
Cash Receipts from Issue of Stock	**40,000**	
Net Cash Flow from Financing Activities		**40,000**
Net Change in Cash		**33,500**
Plus: Beginning Cash Balance		**-0-**
Ending Cash Balance		**$33,500**

c. **Net Income: $12,500 (see the Retained Earnings column in requirement a. There were no dividends paid.)**

d. **Depreciation expense for Year 2: $5,000 (see computation in requirement a; same as Year 1)**

e. **Accumulated Depreciation on December 31, Year 2: $10,000 ($5,000 for Year 1 + $5,000 for Year 2)**

f. **No, depreciation is a noncash expense. Depreciation is the systematic allocation of the cost of an asset to expense. The cash payment occurred when the stove was purchased.**

EXERCISE 2-34B (Appendix)

a. **Compute the depreciation expense per year.**

(Cost – Salvage) ÷ Useful Life = Depreciation expense per year.

($29,000 – $5,000) ÷ 4 = $6,000 per year

Depreciation expense for Year 1 = $6,000
Depreciation expense for Year 2 = $6,000

b. **Accumulated Depreciation for Year 1 is $6,000.**
Accumulated Depreciation for Year 2 is $12,000 ($6,000 depreciation expense for Year 1 and $6,000 depreciation expense for Year 2.)

c. **The statement of cash flows is only affected in Year 1 by the purchase of the taxi cab. It would show an outflow of $29,000 as an investing activity. There is no cash activity associated with the depreciation expense.**

EXERCISE 2-35B (Appendix)

a. $10,000 x 9% = $900; $900 x 4/12 = $300

b. $300

c. $-0-, No interest was paid in Year 1; $900 of interest will be paid in Year 2 when the note matures.

d.

Connelly Company
Statements Model for Year 1

Event No.	Balance Sheet: Assets		Liabilities			+	Stockholders' Equity			Income Statement: Rev.	−	Exp.	=	Net Inc.	Statement of Cash Flows
	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.						
1.	I	=	NA	+	NA	+	NA	+	I	I	−	NA	=	I	I OA
2.	I	=	I	+	NA	+	NA	+	NA	NA	−	NA	=	NA	I FA
3.	NA	=	NA	+	I	+	NA	+	D	NA	−	I	=	D	NA

EXERCISE 2-36B (Appendix)

a. Interest expense recognized for Year 1: $120,000 x 7% = $8,400;
$8,400 x 5/12 = $3,500

b.

California Company Accounting Equation for Year 1									
	Assets	=	Liabilities			+	Equity		
Event	Cash		Note Payable	+	Interest Payable		Common Stock	+	Retained Earnings
Note	120,000	=	120,000	+	NA	+	NA		NA
Adj.	NA		NA		3,500		NA		(3,500)

See the adjusting entry in the accounting equation above (liabilities increase, equity decreases).

c. $-0-. All interest will be paid at maturity, August 1, Year 2, for this note payable.

d. $3,500

e. $8,400 ($120,000 x 7%). All interest will be paid when the note payable matures.

f. $4,900 ($120,000 x 7% x 7/12)

g. $-0-

SOLUTIONS TO PROBLEMS - SERIES B - CHAPTER 2

PROBLEM 2-37B

The Accounting Equation							
	Total Assets		=	Liabilities	+	Stockholders' Equity	
Event/ Adjust.	Cash	Other Assets				Common Stock	Retained Earnings
a.	(6,000)	+6,000	=	NA	+	NA	NA
a. Adj.[1]	NA	(4,500)	=	NA	+	NA	(4,500)
b.	NA	+2,400	=	+2,400	+	NA	NA
b. Adj.[2]	NA	(2,200)	=	NA	+	NA	(2,200)
c.	(7,200)	+7,200	=	NA	+	NA	NA
c. Adj.[3]	NA	(6,000)	=	NA	+	NA	(6,000)
d.	+18,000	NA	=	+18,000	+	NA	NA
d. Adj.[4]	NA	NA	=	(6,000)	+	NA	6,000

[1]$6,000 x 9/12 = $4,500
[2]$2,400 – $200 = $2,200
[3]$7,200 x 10/12 = $6,000
[4]$18,000 x 4/12 = $6,000

PROBLEM 2-38B

a.

Wages Company Income Statement For the Year Ended December 31, Year 2		
Revenue		$18,000
Expenses		
Salary Expense	$13,000	
Utility Expense	1,800	
Rent Expense	1,600	
Total Expense		(16,400)
Net Income		$ 1,600

b.

Accounts to be Closed:	
1.	Revenue
2.	Salary Expense
3.	Utility Expense
4.	Rent Expense
5.	Dividends

PROBLEM 2-38B (cont.)

c.

Computation of Retained Earnings:	
Beginning Retained Earnings	$19,700
Add: Net Income	1,600
Less: Dividends	(1,000)
Ending Retained Earnings	$20,300

Net income only includes revenues and expenses for the current year. Retained earnings not only includes current year net income, but also the balance from previous years and reductions for dividends.

d. **The balances are zero; they were closed to Retained Earnings on December 31, Year 2. The December 31 closing balance of one year is the opening balance on January 1 of the next year.**

PROBLEM 2-39B

Weaver Cleaning Company Effect of Events on the Financial Statements																			
	Balance Sheet													Income Statement					Stmt. of Cash Flows
	Assets					=	Liabilities			+	Stock. Equity			Rev.	–	Exp.	=	Net Inc.	
Event	Cash	+	Accts Rec.	+	Supp.	=	Accts. Pay.	+	Unearn Rev.	+	Com. Stock	+	Ret. Earn.						
1.	15,000	+	NA	+	NA	=	NA	+	NA	+	15,000	+	NA	NA	–	NA	=	NA	15,000 FA
2.	6,000	+	NA	+	NA	=	NA	+	NA	+	NA	+	6,000	6,000	–	NA	=	6,000	6,000 OA
3.	NA	+	18,000	+	NA	=	NA	+	NA	+	NA	+	18,000	18,000	–	NA	=	18,000	NA
4.	11,000	+	(11,000)	+	NA	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	11,000 OA
5.	(1,400)	+	NA	+	1,400	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(1,400) OA
6.	NA	+	NA	+	(1,300)	=	NA	+	NA	+	NA	+	(1,300)	NA	–	1,300	=	(1,300)	NA
7.	3,600	+	NA	+	NA	=	NA	+	3,600	+	NA	+	NA	NA	–	NA	=	NA	3,600 OA
8.	NA	+	NA	+	NA	=	NA	+	(1,800)	+	NA	+	1,800	1,800	–	NA	=	1,800	NA
9.	(6,500)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(6,500)	NA	–	6,500	=	(6,500)	(6,500) OA
10.	NA	+	NA	+	NA	=	2,800	+	NA	+	NA	+	(2,800)	NA	–	2,800	=	(2,800)	NA
11.	(2,100)	+	NA	+	NA	=	(2,100)	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(2,100) OA
12.	(1,000)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(1,000)	NA	–	NA	=	NA	(1,000) FA
Bal.	24,600	+	7,000	+	100	=	700	+	1,800	+	15,000	+	14,200	25,800	–	10,600	=	15,200	24,600 NC

PROBLEM 2-40B

(Prepared for Instructor's Use)

Accounting Equation										
	Assets					Liabilities			Stk. Equity	
Date	Cash	Acc. Rec.	Pp. Rent	Supp.	Land	Acc. Pay.	Sal. Pay.	Unear. Rev.	Com. Stock	Ret. Earn.
Bal.	60,000	45,000			35,000	32,000			60,000	48,000
1/1	30,000								30,000	
4/1	(7,200)		7,200							
6/1	(5,000)									(5,000)
7/1	(40,000)				40,000					
8/1	(21,000)					(21,000)				
9/1	9,600							9,600		
9/30	20,000				(20,000)					
10/1				1,200		1,200				
12/31		75,000								75,000
12/31	62,000	(62,000)								
12/31						27,000				(27,000)
12/31							18,000			(18,000)
12/31				(1,100)						(1,100)
12/31[1]										
12/31a			(5,400)[2]							(5,400)
12/31a								(4,800)[3]		4,800
Bal.	108,400	58,000	1,800	100	55,000	39,200	18,000	4,800	90,000	71,300

[1] No entry for the change in value of the land.
[2] 12/31a Expired Rent ($7,200 x 9/12 = $5,400)
[3] 12/31a Unearned Revenue Earned ($9,600 x 4/8 = $4,800)

PROBLEM 2-40B (cont.)

a. $35,000 + $40,000 – $20,000 = $55,000

b. $62,000 + $9,600 – $7,200 – $21,000 = $43,400

c. $7,200 x 9/12 = $5,400

d. $39,200 + $18,000 + $4,800 =$62,000

e. $1,200 – $100 = $1,100

f. $9,600 – $4,800 ($9,600 x 4/8) = $4,800

g. $20,000 – $40,000 = $(20,000)

h. Total expenses: $27,000 + $18,000 + $1,100 + $5,400 = $51,500

i. $75,000 + $4,800 = $79,800

j. $30,000 – $5,000 = $25,000

k. (j) $79,800 – (i) $51,500 = $28,300

l. Beg. RE $48,000 + NI $28,300 – Div. $5,000 = Ending retained earnings $71,300

PROBLEM 2-41B

Shearer Company Financial Statements For the Year Ended December 31, Year 2		
Income Statement		
Revenue		
Service Revenue	$86,000	
Total Revenue		$86,000
Expenses		
Other Operating Expenses	$59,000	
Supplies Expense	1,000	
Rent Expense	3,500	
Insurance Expense	2,500	
Total Expenses		(66,000)
Net Income		$20,000
Statement of Changes in Stockholders' Equity		
Beginning Common Stock	$ 5,500	
Plus: Stock Issued	9,000*	
Ending Common Stock		$14,500
Beginning Retained Earnings	$47,200	
Plus: Net Income	20,000	
Less: Dividends	(5,000)	
Ending Retained Earnings		62,200
Total Stockholders' Equity		$76,700

*Not given in the problem.

Ending Common Stock – Beginning Common Stock = Stock Issued
$14,500 – $5,500 = $9,000

PROBLEM 2-41B (cont.)

Shearer Company Balance Sheet As of December 31, Year 2		
Assets		
Cash	$22,100	
Accounts Receivable	21,000	
Supplies	2,100	
Prepaid Insurance	3,500	
Land	43,000	
Total Assets		$91,700
Liabilities		
Accounts Payable	$15,000	
Total Liabilities		$15,000
Stockholders' Equity		
Common Stock	$14,500	
Retained Earnings	62,200	
Total Stockholders' Equity		76,700
Total Liab. and Stockholders' Equity		$91,700

PROBLEM 2-41B (cont.)

Shearer Company Statement of Cash Flows For the Year Ended December 31, Year 2	
Cash Flow From Operating Activities	$ 8,600
Cash Flow From Investing Activities	(6,000)
Cash Flow From Financing Activities	9,000
Net Change in Cash	11,600
Plus: Beginning Cash Balance	10,500*
Ending Cash Balance	$22,100

*Not given in the problem.

Ending Cash Bal.	–	Increase in Cash	=	Beg. Cash Balance
$22,100	–	$11,600	=	$10,500

PROBLEM 2-42B

FOR THE YEARS	Year 1	Year 2	Year 3
Income Statements			
Revenue (cash)	$ 400	$ 500	$ 800
Expense (cash)	(250)	(l) (400)	(425)
Net income	(a) $ 150	$ 100	$ 375
Statements of Changes in Stockholders' Equity			
Beginning common stock	$ -0-	(m) $8,000	$9,100
Plus: Common stock issued	(b) 8,000	1,100	310
Ending common stock	8,000	9,100	(s) 9,410
Beginning retained earnings	-0-	25	75
Plus: Net income	(c) 150	100	375
Less: Dividends	(d) (125)	(50)	(150)
Ending retained earnings	25	(n) 75	300
Total stockholders' equity	(e) $8,025	$9,175	(t) $9,710
Balance Sheets			
Assets			
Cash	(f) $11,000	(o) $ 6,650	(u)$ 8,050
Land	-0-	(p) 5,000	2,500
Total assets	$11,000	$11,650	$10,550
Liabilities	(g) $ 2,975	(q) $ 2,475	$ 840
Stockholders' equity			
Common stock	(h) 8,000	(r) 9,100	9,410
Retained earnings	(i) 25	75	300
Total stockholders' equity	8,025	9,175	9,710
Total liabilities and stk. equity	$11,000	$11,650	$10,550

PROBLEM 2-42B (cont.)

FOR THE YEARS	Year 1	Year 2	Year 3
Statements of Cash Flows			
Cash flows from oper. activities:			
Cash receipts from revenue	(j)$ 400	$ 500	(v) $ 800
Cash payments for expenses	(k) (250)	(400)	(w) (425)
Net cash flows from oper. Act.	150	100	375
Cash flows from invest. activities:			
Cash payments for land	-0-	(5,000)	-0-
Cash receipt from sale of land	-0-	-0-	2,500
Net cash flows from invest. act.	-0-	(5,000)	2,500
Cash flows from fin. activities:			
Cash rec. from borrowed funds	2,975	-0-	-0-
Cash payments to reduce debt	-0-	(500)	(x) (1,635)
Cash receipts from stock issue	8,000	1,100	(y) 310
Cash payments for dividends	(125)	(50)	(z) (150)
Net cash flows from fin. activities	10,850	550	(1,475)
Net change in cash	11,000	(4,350)	1,400
Plus: beginning cash balance	-0-	11,000	6,650
Ending cash balance	$11,000	$ 6,650	$ 8,050

PROBLEM 2-42B (cont.)

Computations of amounts:

a. $150 Net Income = $400 Revenue – $250 Expenses.

b. $8,000 Common Stock Issued = $8,000 Ending Common Stock – $-0- Beginning Common Stock.

c. $150 Net Income = $150 Net Income from Income Statement.

d. $125 Dividends = $-0- Beginning Retained Earnings + $150 Net Income – $25 Ending Retained Earnings.

e. $8,025 Total Stockholders' Equity = $8,000 Ending Common Stock + $25 Ending Retained Earnings.

f. $11,000 Cash = $11,000 Total Assets – $-0- Land.

g. $2,975 Liabilities = $11,000 Total Liabilities and Stockholders' Equity – $8,025 Total Stockholders' Equity.

h. $8,000 Common Stock = $8,000 Ending Common Stock from Statement of Changes in Stockholders' Equity.

i. $25 Retained Earnings = $25 Ending Retained Earnings from Statement of Changes in Stockholders' Equity.

j. $400 Cash Receipts from Revenue = $400 Revenue from Income Statement.

k. $250 Cash Payments for Expenses = $250 Expenses from Income Statement.

l. $400 Expenses = $500 Revenue – $100 Net Income.

m. $8,000 Beginning Common Stock = $8,000 Ending Common Stock for Year 1.

n. $75 Ending Retained Earnings = $25 Beginning Retained Earnings + $100 Net Income – $50 Dividends.

o. $6,650 Cash = $6,650 Ending Cash Balance from the Statement of Cash Flows.

p. $5,000 Land = $11,650 Total Assets – $6,650 Cash.

q. $2,475 Liabilities = $11,650 Total Liabilities and Stockholders' Equity – $9,175 Total Stockholders' Equity.

r. $9,100 Common Stock = $9,100 Ending Common Stock from Statement of Changes in Stockholders' Equity.

s. $9,410 Ending Common Stock = $9,100 Beginning Common Stock + $310 Stock issued.

t. $9,710 Total Stockholders' Equity = $9,410 Ending Common Stock + $300 Ending Retained Earnings.

u. $8,050 Cash = $10,550 Total Assets – $2,500 Land.

v. $800 Cash Receipts from Revenue = $800 Revenue from Income Statement.

w. $425 Cash Payments for Expenses = $425 Expenses from Income Statement.

x. $1,635 Cash Payments to Reduce Debt = $2,475 Liabilities Balance, Year 2 – $840 Liabilities Balance, Year 3.

y. $310 Cash Receipts from Stock Issue = $310 Common Stock Issued from Statement of Changes in Stockholders' Equity.

z. $150 Cash Payments for Dividends = $150 Dividends from Statement of Changes in Stockholders' Equity.

PROBLEM 2-43B

a.

Iowa Service Company
Accounting Equation for Year 1

		Assets					=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	=	Accts. Pay.	Salaries Payable	Unearn. Rev.	+	Com. Stock	Retained Earnings
1.	AS	60,000	NA	NA	NA	NA	=	NA	NA	NA	+	60,000	NA
2.	AS	NA	NA	1,200	NA	NA	=	1,200	NA	NA	+	NA	NA
3.	AE	(18,000)	NA	NA	NA	18,000	=	NA	NA	NA	+	NA	NA
4.	AU	(800)	NA	NA	NA	NA	=	(800)	NA	NA	+	NA	NA
5.	AS	NA	42,000	NA	NA	NA	=	NA	NA	NA	+	NA	42,000
6.	AU	(21,000)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(21,000)
7.	AE	38,000	(38,000)	NA	NA	NA	=	NA	NA	NA	+	NA	NA
8.	CE	NA	NA	NA	NA	NA	=	NA	3,200	NA	+	NA	(3,200)
9.	AU	NA	NA	(1,000)	NA	NA	=	NA	NA	NA	+	NA	(1,000)
Totals		58,200	4,000	200	-0-	18,000	=	400	3,200	-0-	+	60,000	16,800

PROBLEM 2-43B (cont.)

a.

Iowa Service Company
Accounting Equation for Year 2

		Assets					=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	=	Accts. Pay.	Salaries Payable	Unearn. Revenue	+	Com. Stock	Retained Earnings
Bal.		58,200	4,000	200	-0-	18,000	=	400	3,200	-0-	+	60,000	16,800
1.	AS	20,000	NA	NA	NA	NA	=	NA	NA	NA	+	20,000	NA
2.	AU	(3,200)	NA	NA	NA	NA	=	NA	(3,200)	NA	+	NA	NA
3.	AE	(3,600)	NA	NA	3,600	NA	=	NA	NA	NA	+	NA	NA
4.	AE	15,000	NA	NA	NA	(15,000)	=	NA	NA	NA	+	NA	NA
5.	AS	4,800	NA	NA	NA	NA	=	NA	NA	4,800	+	NA	NA
6.	AS	NA	NA	1,000	NA	NA	=	1,000	NA	NA	+	NA	NA
7.	AS	NA	32,000	NA	NA	NA	=	NA	NA	NA	+	NA	32,000
8.	AE	33,000	(33,000)	NA	NA	NA	=	NA	NA	NA	+	NA	NA
9.	AU	(5,000)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(5,000)
10.	AU	(19,500)	NA	NA	NA	NA	=	NA	NA	NA	+	NA	(19,500)
11.	AU	NA	NA	NA	(3,000)[1]	NA	=	NA	NA	NA	+	NA	(3,000)
12.	CE	NA	NA	NA	NA	NA	=	NA	NA	(1,200)[2]	+	NA	1,200
13.	AU	NA	NA	(900)	NA	NA	=	NA	NA	NA	+	NA	(900)
14.	CE	NA	NA	NA	NA	NA	=	NA	3,900	NA	+	NA	(3,900)
Totals		99,700	3,000	300	600	3,000	=	1,400	3,900	3,600	+	80,000	17,700

[1]\$3,600 x 10/12 = \$3,000
[2]\$4,800 x 3/12 = \$1,200

PROBLEM 2-43B (cont.)

b.

Iowa Service Company
Financial Statements
For the Years Ended December 31, Year 1 and Year 2

Income Statements		
	Year 1	Year 2
Service Revenue	$ 42,000	$ 33,200
	42,000	33,200
Expenses		
Operating Expenses	(21,000)	(19,500)
Supplies Expense	(1,000)	(900)
Salaries Expense	(3,200)	(3,900)
Rent Expense	-0-	(3,000)
Total Expenses	(25,200)	(27,300)
Net Income	$16,800	$ 5,900
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$60,000
Plus: Stock Issued	60,000	20,000
Ending Common Stock	60,000	80,000
Beginning Retained Earnings	-0-	16,800
Plus: Net Income	16,800	5,900
Less: Dividends	-0-	(5,000)
Ending Retained Earnings	16,800	17,700
Total Stockholders' Equity	$76,800	$97,700

b.

Iowa Service Company Balance Sheets As of December 31, Year 1 and Year 2		
	Year 1	Year 2
Assets		
Cash	$58,200	$99,700
Accounts Receivable	4,000	3,000
Supplies	200	300
Prepaid Rent	-0-	600
Land	18,000	3,000
Total Assets	$80,400	$106,600
Liabilities		
Accounts Payable	$ 400	$ 1,400
Salaries Payable	3,200	3,900
Unearned Revenue	-0-	3,600
Total Liabilities	3,600	8,900
Stockholders' Equity		
Common Stock	60,000	80,000
Retained Earnings	16,800	17,700
Total Stockholders' Equity	76,800	97,700
Total Liab. and Stockholders' Equity	$80,400	$106,600

PROBLEM 2-43B (cont.)

b.

Iowa Service Company Statements of Cash Flows For the Years Ended December 31, Year 1 and Year 2		
	Year 1	Year 2
Cash Flows From Operating Activities:		
Cash Received from Customers	$38,000	$37,800
Cash Payment for Expenses[1]	(21,800)	(26,300)
Net Cash Flow from Operating Activities	16,200	11,500
Cash Flows From Investing Activities:		
Cash Payment for Land	(18,000)	-0-
Cash Proceeds from Sale of Land		15,000
Net Cash Flow From Investing Activities	(18,000)	15,000
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	60,000	20,000
Cash Payment for Dividends	-0-	(5,000)
Net Cash Flow From Financing Activities	60,000	15,000
Net Change in Cash	58,200	41,500
Plus: Beginning Cash Balance	-0-	58,200
Ending Cash Balance	$58,200	$99,700

[1]Year 1: $800 + $21,000 = $21,800
Year 2: $3,200 + $3,600 + $19,500 = $26,300

PROBLEM 2-44B

a. Several of the principles should be mentioned in the memo.

   Responsibilities Principle
   As a professional, Kato should exercise professional and moral judgment in his position.

   Integrity Principle
   Kato should perform his duties with the highest sense of integrity.

   Due Care Principle
   Members are required be competent in their areas of responsibility and to perform professional duties to the best of his/her ability.

b. Pleading ignorance would not relieve Kato of responsibility. The due care principle requires that members of the profession be competent and provide quality services.

PROBLEM 2-45B

(Prepared for Instructor's Use)

	Accounting Equation													
	Assets							Liabilities					Stk. Equity	
Date	Cash	Acc. Rec.	Pp. Rent	Supp	Van	Acc. Depr.	Land	Acc. Pay.	Sal. Pay.	Note Pay.	Int. Pay.	Unear. Rev.	Com. Stock	Ret. Earn.
Bal.	61,000	45,000					27,000	25,000					90,000	18,000
1/1	70,000												70,000	
1/1	(26,000)				26,000									
3/1	21,000									21,000				
4/1	(6,600)		6,600											
6/1	(3,000)													(3,000)
7/1	(25,000)						25,000							
8/1	(13,000)							(13,000)						
9/1	8,400											8,400		
10/1				900				900						
12/31		80,000												80,000
12/31	56,000	(56,000)												
12/31								16,000						(16,000)
12/31									5,000					(5,000)
12/31				(650)										(650)
12/31a1						(3,800)[1]								(3,800)
12/31a2											1,400[2]			(1,400)
12/31a3			(4,950)[3]											(4,950)
12/31a4												(4,200)[4]		4,200
Bal.	142,800	69,000	1,650	250	26,000	(3,800)	52,000	28,900	5,000	21,000	1,400	4,200	160,000	67,600

(1) 12/31a Depreciation Expense ($26,000 – $7,000 = $19,000; $19,000 ÷ 5 = $3,800 per year)
(2) 12/31a Interest Expense ($21,000 x 8% = $1,680; $1,680 x 10/12 = $1,400)
(3) 12/31a Expired Rent ($6,600 x 9/12 = $4,950)
(4) 12/31a Unearned Revenue Earned ($8,400 x 4/8 = $4,200)

PROBLEM 2-45B (cont.)

a. The four transactions that need adjusting entries are as follows:
   1. March 1, note payable issued. Interest expense is recorded.
   2. April 1, prepaid rent. Expired rent is recorded.
   3. Sept. 1, unearned revenue; cash was received in advance. Earned revenue is recorded.
   4. Nov. 1, purchase of CD. Interest revenue is recorded.

b. $21,000 x 8% x 10/12=$1,400.

c. $56,000 + $8,400 – $6,600 – $13,000 = $44,800

d. $6,600 x 9/12 = $4,950

e. $60,500 (see total of liabilities columns; $28,900 + $5,000 + $21,000 + $1,400 + $4,200).

f. $900 – $250 = $650

g. $4,200 = $8,400 – $4,200 ($8,400 x 4/8)

h. $(51,000) = [$(26,000) + $(25,000)]

i. $21,000 x 8% x 10/12 = $1,400

j. Total expenses, $31,800
($5,000 + $16,000 + $650 + $4,950 + $3,800 + $1,400)

k. Ending retained earnings $67,600 (Beg. RE $18,000 + NI $52,600 – Div. $3,000)

l. All service revenues $84,200 = $80,000 + $4,200

m. $88,000 = $70,000 + $21,000 – $3,000

n. $52,400 = (l) $84,200 – (j) $31,800

SOLUTIONS TO COMPREHENSIVE PROBLEM – CHAPTER 2

Pacilio Security Services, Inc.

Event	Cash	+	Acct. Rec.	+	Supp.	+	Pp. Rent	+	Land	=	Accts. Pay	+	Sal. Pay.	+	Unear. Rev.	+	Notes Pay.	+	Com. Stock	+	Ret. Earn.	Acct. Titles
B. Bal.	8,500	+	NA	+	NA	+	NA	+	4,000	=	NA	+	NA	+	NA	+	5,000	+	6,000	+	1,500	
1.	2,000	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	2,000	+	NA	
2.	(3,000)	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	(3,000)	+	NA	+	NA	
3.	6,000	+	15,000	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	21,000	Rev.
4.	(2,400)	+	NA	+	NA	+	2,400	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	NA	
5.	NA	+	NA	+	650	+	NA	+	NA	=	650	+	NA	+	NA	+	NA	+	NA	+	NA	
6.	(8,000)	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	(8,000)	Sal.
7.	NA	+	NA	+	NA	+	NA	+	NA	=	6,200	+	NA	+	NA	+	NA	+	NA	+	(6,200)	Op. Ex
8.	600	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	600	+	NA	+	NA	+	NA	
9.	13,500	+	(13,500)	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	NA	
10.	(5,800)	+	NA	+	NA	+	NA	+	NA	=	(5,800)	+	NA	+	NA	+	NA	+	NA	+	NA	
11.	(1,500)	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	(1,500)	Adv.
12.	(1,000)	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	(1,000)	Div.
13.*	NA	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	NA	
14.	NA	+	NA	+	(585)	+	NA	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	(585)	Sup.
15.[1]	NA	+	NA	+	NA	+	(1,600)	+	NA	=	NA	+	NA	+	NA	+	NA	+	NA	+	(1,600)	Rent
16.[2]	NA	+	NA	+	NA	+	NA	+	NA	=	NA	+	NA	+	(400)	+	NA	+	NA	+	400	Rev.
17.	NA	+	NA	+	NA	+	NA	+	NA	=	NA	+	1,200	+	NA	+	NA	+	NA	+	(1,200)	Sal.
Bal.	8,900	+	1,500	+	65	+	800	+	4,000	=	1,050	+	1,200	+	200	+	2,000	+	8,000	+	2,815	

***No adjustment is required for change in market value.**
[1]$2,400 x 8/12 = $1,600
[2]$600 x 4/6 = $400

COMPHREHENSIVE PROBLEM - CHAPTER 2 (cont.)

b.

Pacilio Security Services, Inc. Income Statement For the Year Ended December 31, Year 2		
Service Revenue		$21,400
Expenses		
Salaries Expense	$9,200	
Other Operating Expenses	6,200	
Advertising Expense	1,500	
Supplies Expense	585	
Rent Expense	1,600	
Total Expenses		19,085
Net Income		$ 2,315

Pacilio Security Services, Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 2		
Beginning Common Stock	$6,000	
Plus: Common Stock Issued	2,000	
Ending Common Stock		$ 8,000
Beginning Retained Earnings	$1,500	
Plus: Net Income	2,315	
Less: Dividends	(1,000)	
Ending Retained Earnings		2,815
Total Stockholders' Equity		$10,815

COMPREHENSIVE PROBLEM - CHAPTER 2 (cont.)

b.

Pacilio Security Services, Inc. Balance Sheet As of December 31, Year 2		
Assets		
Cash	$8,900	
Accounts Receivable	1,500	
Supplies	65	
Prepaid Rent	800	
Land	4,000	
Total Assets		$15,265
Liabilities		
Accounts Payable	$1,050	
Unearned Revenue	200	
Salaries Payable	1,200	
Notes Payable	2,000	
Total Liabilities		$ 4,450
Stockholders' Equity		
Common Stock	$8,000	
Retained Earnings	2,815	
Total Stockholders' Equity		10,815
Total Liabilities and Stockholders' Equity		$15,265

COMPREHENSIVE PROBLEM - CHAPTER 2 (cont.)

b.

Pacilio Security Services, Inc. Statement of Cash Flows For the Year Ended December 31, Year 2		
Cash Flows From Operating Activities:		
Cash Receipts from Customers[1]	$20,100	
Cash Payment for Expenses[2]	(17,700)	
Net Cash Flow from Operating Activities		$2,400
Cash Flows From Investing Activities:		
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	$ 2,000	
Cash Payments on Loan	(3,000)	
Cash Payments for Dividends	(1,000)	
Net Cash Flow from Financing Activities		(2,000)
Net Increase in Cash		400
Plus: Beginning Cash Balance		8,500
Ending Cash Balance		$8,900

[1]Cash Receipts from Customers:

Cash Sales	$6,000	
Cash received from unearned income	600	
Collection of Accounts Receivable	13,500	
Total Cash from Customers		$20,100

[2]Cash Payment for Expenses

Payment of Prepaid Rent	$2,400	
Payment of Salaries	8,000	
Payment of Accounts Payable	5,800	
Payment of Advertising	1,500	
Total Cash Payment for Expenses		$17,700

ANSWERS TO QUESTIONS - CHAPTER 2

1. **Accrual accounting attempts to record the effects of accounting events in the period when such events occur, regardless of when cash is received or paid. The goal is to match expenses with the revenues that they produce.**

2. **Recognition is the act of recording an event in the financial statements. When accruals are used, events are recognized before the associated cash is paid or collected.**

3. **Deferral is the recognition of revenue or expenses in a period after the cash consequences are realized, i.e., cash is collected in advance of performing the service.**

4. **If cash is collected in advance for services, the revenue is recognized when the services are rendered.**

5. **An asset source transaction increases assets and increases either liabilities or equity.**

6. **The issue of common stock, which is capital acquired from owners, increases business assets (usually cash) and equity (common stock).**

7. **The recognition of revenue on account increases the corresponding revenue account on the income statement, but does not affect the statement of cash flows. The cash flow statement is affected when the account is collected.**

8.	**Asset Source Transaction**	**Effect on Accounting Equation**
Issue of Common Stock	**Increases Assets, Increases Common Stock**
Revenue Earned	**Increases Assets, Increases Retained Earnings**
Borrowed Funds	**Increases Assets, Increases Liabilities**

9. Revenue is recognized under accrual accounting when a revenue-producing event occurs, i.e., when the revenue is *earned*, even if no cash is collected at the time of the transaction.

10. The collection of cash for accounts receivable is an asset exchange transaction. Only the asset side of the accounting equation is affected because one asset account increases (cash), and another asset account decreases (accounts receivable). Total assets are unchanged.

11. If cash is collected in advance for services, a liability is created (unearned revenue), increasing the claims side of the accounting equation.

12. Unearned revenue is cash that has been collected for services that have not yet been performed.

13. The recognition of expenses affects the accounting equation by either decreasing assets or increasing liabilities (payables) and by decreasing stockholders' equity (retained earnings).

14. A claims exchange transaction is one where the claims of creditors (liabilities) increase and the claims of stockholders (retained earnings) decrease, or vice versa. The total amount of claims is unchanged.

15. Cash payments to creditors are <u>asset use</u> transactions. These transactions result in the reduction of an asset account (cash)

and the reduction of the corresponding liability account (payables).

16. Expenses are recognized under accrual accounting at the time the expense is incurred or resources are consumed, regardless of when cash payment is made.

17. Net cash flows from operations on the cash flow statement may be different from net income because of the application of accrual accounting. Revenues and expenses reported on the income statement may be recognized before or after the actual collection or payment of cash that is reported on the cash flow statement.

18. The income statement reflects the change in net assets associated with operating a business, as shown by revenues and expenses. Expenses may result from a decrease in assets or an increase in liabilities. Revenues may result from an increase in assets or a decrease in liabilities.

19. Net income increases stockholders' claims on business assets by increasing retained earnings.

20. A cost can be either an asset or an expense. If the item acquired has already been used in the process of earning revenue, its cost represents an expense. If the item will be used in the future to generate revenue, its cost represents an asset.

21. A cost is held in the asset account until the item is used to produce revenue. When the revenue is generated, the asset is converted into an expense in order to match revenues with related expenses. Not all costs become expenses. If the value of an asset will not expire in the revenue-generating process, the asset will not become an expense. For example, the cost of land will not become an expense.

22. **Supplies used during the accounting period are recognized in a single adjusting entry at the end of the period. The amount of supplies used is determined by subtracting the amount of supplies on hand at the end of the period from the amount of supplies that were available for use (beginning supplies balance plus supplies purchased).**

23. **An expense is a decrease in assets or an increase in liabilities that occurs in the process of generating revenue.**

24. **Revenue is an increase in assets or a decrease in liabilities that results from the operating activities of the business.**

25. **The purpose of the statement of changes in stockholders' equity is to display the effects of business operations and stock issued to owners and dividends paid to stockholders. It identifies the ways that an entity's equity increased and decreased as a result of its operations and transactions with its stockholders.**

26. **The purpose of the balance sheet is to provide information about an entity's assets, liabilities, and stockholders' equity and their relationships to each other at a particular point in time. It provides a list of the economic resources that the enterprise has available for its operating activities and the claims to those resources.**

27. **The balance sheet is dated as of a specific date because it shows information about an entity's assets, liabilities, and stockholders' equity as of that date, not measured over a time period. The statement of changes in stockholders' equity, the income statement, and the statement of cash flows reflect transactions that occur over a period of time.**

28. **Assets are listed on the balance sheet in accordance with their respective levels of liquidity (how rapidly they can be converted to cash).**

29. The statement of cash flows explains the change in cash from one accounting period to the next. It is prepared by analyzing the cash account and summarizing where cash came from and how it was used.

30. An adjusting entry is an entry that updates account balances prior to preparation of the financial statements. The entry means that there is an item that needs proper measurement on the income statement and an adjustment will reflect the correct time period of earning or usage. Example: entry to recognize accrued interest revenue where the revenue has been earned but not yet collected and therefore revenue had not yet been recorded for the time period.

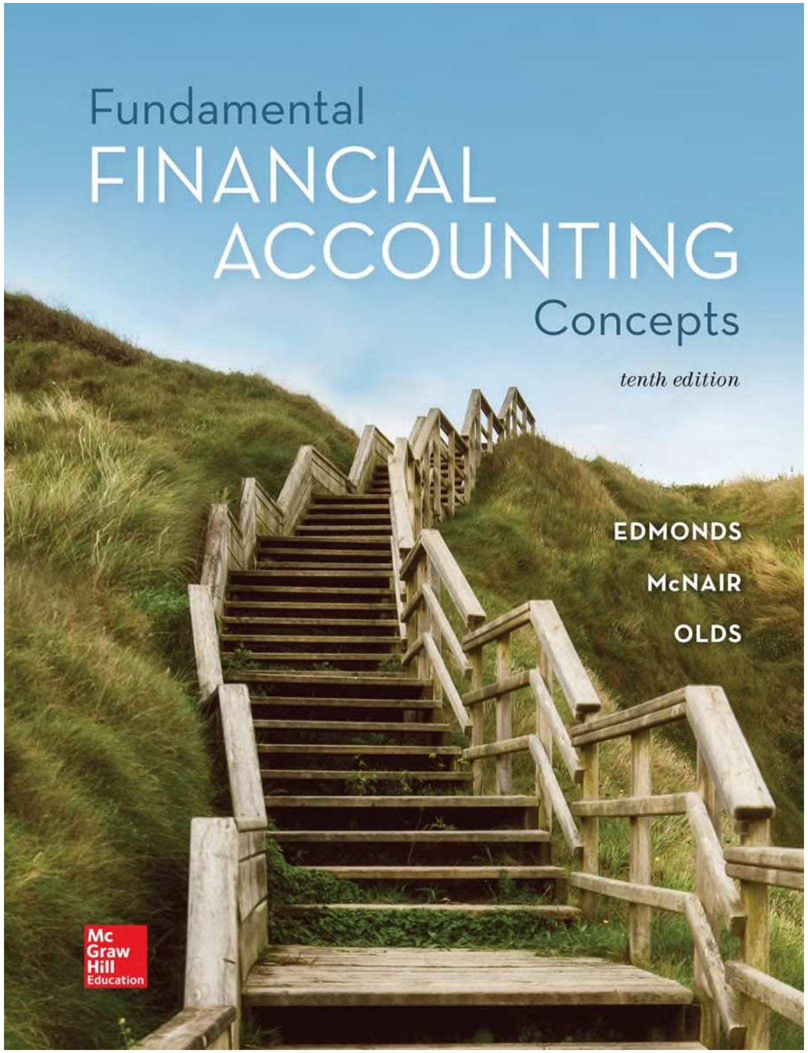
31. Temporary accounts (revenue, expense and dividends) are closed at the end of the accounting period. It is necessary to close these accounts so that revenue, expense and dividends can be accumulated from a beginning balance of zero for the next period.

32. Period costs are costs that are recognized in an accounting period. Examples of period costs include rent expense, utilities expense, and salaries expense.

33. Salary of the tax return preparer could be directly matched with the revenue that it produces.

34. The four stages of the accounting cycle: Record transactions; adjust the accounts; prepare statements; and close the temporary accounts. The adjustment and closing processes have been added to the cycle in this chapter. It is necessary to adjust accounts so that the accounts will reflect the correct balances under the accrual basis of accounting. The closing process (transferring the balances of the temporary accounts to retained earnings) is necessary so that the temporary accounts have a zero balance at the beginning of the next accounting cycle.

Chapter 2
Accounting for Accruals and Deferrals



SECTION 1

SHOW HOW ACCRUALS AFFECT FINANCIAL STATEMENTS

Cash Basis Versus Accrual Accounting

- **Recognition results in** formally recording an economic item or event in the financial statements.
- **Realization results in** collecting cash, generally from the sale of products or services.

LO 2-1: Show how receivables affect financial statements.

Event 1

- Cato Consultants was started on January 1, Year 1, when it acquired $5,000 cash by issuing common stock.
- This **asset source transaction**: (1) increases assets (Cash) and (2) increases stockholders' equity (Common Stock).

Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Supplies	=		+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		Cash Flow	
5,000	+	n/a	=	n/a	+	5,000	+	n/a		n/a	–	n/a	=	n/a		5,000	FA

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Event 2

- During Year 1, Cato Consultants provided $84,000 of consulting services to its clients but no cash has been collected.
- This **asset source transaction**: (1) increases assets (Accounts Receivable) and (2) increases stockholders' equity (Retained Earnings).

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Accts Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
n/a	+	84,000	=	n/a	+	n/a	+	84,000		84,000	−	n/a	=	84,000		n/a

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Event 3

- Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.
- This **asset exchange transaction**: (1) increases assets (Cash) and (2) decreases assets (Accounts Receivable).

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income	Cash Flow
60,000	+	(60,000)	=	n/a	+	n/a	+	n/a	n/a	−	n/a	=	n/a	60,000 OA

Event 4

- Cato paid the instructor $10,000 cash for teaching training courses (salary expense).
- This **asset use transaction**: (1) decreases assets (Cash) and (2) decreases stockholders' equity (Retained Earnings).

Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Accts Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		Cash Flow	
(10,000)	+	n/a	=	n/a	+	n/a	+	(10,000)		n/a	–	10,000	=	(10,000)		(10,000)	OA

Event 5

- Cato paid $2,000 for advertising costs. The advertisements appeared in Year 1.
- This **asset use transaction**: (1) decreases assets (Cash) and (2) decreases stockholders' equity (Retained Earnings).

Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Accts Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow	
(2,000)	+	n/a	=	n/a	+	n/a	+	(2,000)		n/a	−	2,000	=	(2,000)		(2,000)	OA

LO 2-2: Show how payables affect financial statements.

Event 6

- At the end of Year 1, Cato recorded accrued salary expense of $6,000. The salary expense is for courses the instructor taught in Year 1. However, Cato will not pay the instructor cash until Year 2.
- This **claims exchange transaction**: (1) increases liabilities (Salaries Payable) and (2) decreases stockholders' equity (Retained Earnings). The entry, required to update account balances, is called an **adjusting entry**.

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Accts Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
n/a	+	n/a	=	6,000	+	n/a	+	(6,000)		n/a	−	n/a	=	(6,000)		n/a

Event 7

- Cato signed contracts for $42,000 of consulting services to be performed in Year 2.
- This event is **not recognized** in the Year 1 financial statements.

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Prepaid Rent	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
n/a	+	n/a	=	n/a	+	n/a	+	n/a		n/a	−	n/a	=	n/a		n/a

LO 2-3: Prepare financial statements that include accruals.

Exhibit 2.2: Vertical Statements Model

CATO CONSULTANTS	
Financial Statements	
December 31, Year 1	
Income Statement	
	Year 1
Revenue	$ 84,000
Depreciation Expense	(18,000)
Net Income	$ 66,000
Statement of Changes in Stockholders' Equity	
	Year 1
Beginning Common Stock	$ 0
Plus: Common Stock Issued	5,000
Ending Common Stock	5,000
Beginning Retained Earnings	0
Plus: Net Income	66,000
Less: Dividends	0
Ending Retained Earnings	66,000
Total Stockholders' Equity	$ 71,000
Balance Sheets	
Assets	Year 1
Cash	$ 53,000
Accounts Receivable	24,000
Supplies	0
Prepaid Rent	0
Land	0
Total Assets	$77,000
Liabilities	
Accounts Payable	$0
Unearned Revenue	0
Salaries Payable	6,000
Total Liabilities	6,000
Stockholders' Equity	
Common Stock	5,000
Retained Earnings	66,000
Total Stockholders' Equity	71,000
Total Liabilities and Stockholders' Equity	$77,000
Statement of Cash Flows	
Cash Flows from operating activities	
Cash receipts from Customers	$60,000
Cash payments for operating expenses	(12,000)
Net cash flows from Operating Activities	48,000
Cash Flows from investing activities	
Cash Payment to purchase land	0
Cash Flows from financing activities	
Cash receipts from issuing common stock	5,000
Cash payments for dividends	0
Net cash flow from financing activities	5,000
Net change in Cash	53,000
Plus Beginning Cash Balance	0
Ending Cash Balance	$53,000

Comparing Cash Flow from Operating Activities with Net Income

	Accrual Accounting	Cash Flow
Consulting Revenue	$84,000	$60,000
Salary Expense	(16,000)	(10,000)
Advertising Expense	(2,000)	(2,000)
Net income	$66,000	$48,000

LO 2-4: Identify the steps in the accounting cycle.

The Closing Process

- The closing process accomplishes <u>two</u> important functions:
  1. It transfers net income (or loss) and dividends to **Retained Earnings**.
  2. It establishes **zero** balances in all revenue, expense, and dividend accounts.

Temporary and Permanent Accounts

Temporary Accounts include:	Permanent Accounts include:
• Expenses	• Assets
• Revenues	• Liabilities
• Dividends	• Equity
Temporary accounts track financial results for a limited period of time.	Permanent accounts track financial results from year to year.

Steps in an Accounting Cycle

You can imagine the accounting cycle

as a circle that begins with:

(1) **Recording transactions**,

then (2) **Adjusting accounts** in order to

(3) **Prepare statements**, and finally

(4) **Close Nominal or temporary accounts**

in order to start the accounting process

all over again for the next accounting period.

Matching Concept

- Cash basis accounting can distort the measurement of net income because it sometimes fails to properly match revenues with expenses.
- The problem is that cash is not always received or paid in the period when the revenue is earned or when the expense is incurred.
- The objective of accrual accounting is to improve matching of revenues with expenses.

SECTION 2

SHOW HOW DEFERRALS AFFECT FINANCIAL STATEMENTS

LO 2-5: Show how accounting for supplies affects financial statements.

Second Accounting Cycle: Event 1

- Cato pays $6,000 to the instructor to settle the salaries payable obligation.
- This **asset use transaction:** (1) decreases assets (Cash) and (2) decreases liabilities (Salaries Payable).

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Accts. Rec.	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a		n/a	−	n/a	=	n/a		(6,000) OA

Second Accounting Cycle: Event 2

- Cato purchased $800 of supplies on account.
- This **asset source transaction**: (1) increases assets (Supplies) and (2) increases liabilities (accounts payable).

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Supplies	=	AccountsPayable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
n/a	+	800	=	800	+	n/a	+	n/a		n/a	−	n/a	=	n/a		n/a

Adjustment 1

- After determining through a physical count that it had $150 of unused supplies on hand as of December 31, Cato recognized supplies expense.
- The result of this **asset use transaction** is that it is recorded in two places: (1) as a decrease in assets (Supplies) and (2) as a decrease in stockholders' equity (Retained Earnings).

Beginning Supplies Balance, $0	+	Supplies Purchased, $800	=	Supplies available for use, $800	−	Ending Supplies Balance, $150	=	Supplies Used, $650

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Supplies	=	Accounts Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income	Cash Flow
n/a	+	(650)	=	n/a	+	n/a	+	(650)		n/a	−	650	=	(650)	n/a

LO 2-6: Show how accounting for prepaid items affects financial statements.

Second Accounting Cycle: Event 3

- On March 1, Year 2, Cato signed a one-year lease agreement and paid $12,000 cash in advance to rent office space. The one-year lease term begins March 1.
- The result of this **asset exchange transaction** is that it is recorded in two places: (1) Cato decreases assets (Cash) and (2) increases assets (Prepaid Rent).

Assets			=	Liab.	+	Stockholders' Equity										Cash Flow	
Cash	+	Prepaid Rent	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow	
(12,000)	+	12,000	=	n/a	+	n/a	+	n/a		n/a	−	n/a	=	n/a		(12,000)	OA

Accounting for Prepaid Items

Exhibit 2.5: Relationship between Costs, Assets, and Expenses

Costs	Result in	Assets (deferred expense), like Prepaid Rent	When used result in	Expenses, like Rent Expense
OR				
Costs	Directly Result in			Expenses, like Utilities Expense

Adjustment 2

- Cato recognized rent expense for the office space used during the accounting period.
- The result of this **asset use transaction** is that it is recorded in two places: (1) as a decrease in assets (Prepaid Rent) and (2) as a decrease in stockholders' equity (Retained Earnings).

$12,000 Cost of annual lease ÷ 12 Months = $1,000 Cost per month
$1,000 Cost per month × 10 Months used = $10,000 Rent expense

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Prepaid Rent	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income	Cash Flow
n/a	+	(10,000)	=	n/a	+	n/a	+	(10,000)		n/a	−	10,000	=	(10,000)	n/a

LO 2-7: Show how accounting for unearned revenues affects financial statements.

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Second Accounting Cycle: Event 4

- Cato received $18,000 cash in advance from Westberry Company for consulting services to be performed over a one-year period beginning June 1, Year 2.
- The result of this **asset source transaction** is that it is recorded in two places: (1) as an increase in assets (Cash) and (2) as an increase in liabilities (Unearned Revenue).

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Prepaid Rent	=	Unearned Revenue	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow
18,000	+	n/a	=	18,000	+	n/a	+	n/a		n/a	−	n/a	=	n/a		18,000 OA

Adjustment 3

- Cato recognizes the portion of the unearned revenue it earned during the accounting period.
- The result of this **claims exchange transaction** is that it is recorded in two places: (1) as a decrease in liabilities (Unearned Revenue) and (2) an increase in stockholders' equity (Retained Earnings).

$18,000 ÷ 12 months = $1,500 revenue earned per month
$1,500 × 7 months = $10,500 revenue to be recognized in Year 2

Assets			=	Liab.	+	Stockholders' Equity										Cash Flow
Cash	+	Prepaid Rent	=	Unearned Revenue	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		Cash Flow
n/a	+	n/a	=	(10,500)	+	n/a	+	10,500		10,500	–	n/a	=	10,500		n/a

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LO 2-8: Prepare financial statements that include deferrals.

Other Year 2 Events

- Event 5 **provided $96,400 of consulting services on account.**
- Event 6 **collected $105,000 cash from customers as partial settlement of accounts receivable.**
- Event 7 **paid $32,000 for salary expense.**
- Event 8 **incurred $21,000 of other operating expenses on account.**
- Event 9 **paid $18,200 in partial settlement of accounts payable.**

Other Year 2 Events (Continued)

- Event 10 **paid $79,500 to purchase land it planned to use in the future as a building site for its home office.**
- Event 11 **paid $21,000 in cash dividends to its stockholders.**
- Event 12 **acquired $2,000 cash from issuing additional shares of common stock.**
- Adj. 4 **recognized $4,000 of accrued salary expense**.

Exhibit 2.7: Preparing Financial Statements

CATO CONSULTANTS		
Financial Statements		
December 31, Year 1 and 2		
Income Statement		
	Year 1	Year 2
Revenue	$ 84,000	$ 106,900
Depreciation Expense	(18,000)	(67,650)
Net Income	$ 66,000	$ 39,250
Statement of Changes in Stockholders' Equity		
	Year 1	Year 2
Beginning Common Stock	$ 0	$ 5,000
Plus: Common Stock Issued	5,000	2,000
Ending Common Stock	5,000	7,000
Beginning Retained Earnings	0	66,000
Plus: Net Income	66,000	39,250
Less: Dividends	0	(21,000)
Ending Retained Earnings	66,000	84,250
Total Stockholders' Equity	$ 71,000	$ 91,250
Balance Sheets		
Assets	Year 1	Year 2
Cash	$ 53,000	$ 9,300
Accounts Receivable	24,000	15,400
Supplies	0	150
Prepaid Rent	0	2,000
Land	0	79,500
Total Assets	$77,000	$ 106,350
Liabilities		
Accounts Payable	$0	$ 3,600
Unearned Revenue	0	7,500
Salaries Payable	6,000	4,000
Total Liabilities	6,000	15,100
Stockholders' Equity		
Common Stock	5,000	7,000
Retained Earnings	66,000	84,250
Total Stockholders' Equity	71,000	91,250
Total Liabilities and Stockholders' Equity	$77,000	$ 106,350
Statement of Cash Flows		
Cash Flows from operating activities		
Cash receipts from Customers	$60,000	$123,000
Cash payments for operating expenses	(12,000)	(68,200)
Net cash flows from Operating Activities	48,000	54,800
Cash Flows from investing activities		
Cash Payment to purchase land	0	(79,500)
Cash Flows from financing activities		
Cash receipts from issuing common stock	5,000	2,000
Cash payments for dividends	0	(21,000)
Net cash flow from financing activities	5,000	(19,000)
Net change in Cash	53,000	(43,700)
Plus Beginning Cash Balance	0	53,000
Ending Cash Balance	$53,000	$9,300

LO 2-9: Classify accounting events into one of four categories.

Recap: Types of Transactions

The described transactions can be classified into one of four categories:			
Asset Source	**Asset Use**	**Asset Exchange**	**Claims Exchange**
Increase assets	Decrease assets	Increase one asset	Increase one claims account
Increase claims on assets	Decrease claims on assets	Decrease another asset	Decrease another claims account

LO 2-10: Discuss the primary components of corporate governance.

Corporate Governance

- **Corporate governance** is the set of relationships between the board of directors, management, shareholders, auditors, and other stakeholders that determines how a company is operated.

McGraw Hill Education

Importance of Ethics

- The accountant's role requires trust and credibility.
- Accounting information is worthless if the accountant is not trustworthy.
- Therefore, the accounting profession requires high ethical standards.

AICPA Code of Professional Conduct

- Includes articles requiring CPAs to:
  - exercise sensitive professional and moral judgments.
  - act in a way to serve the public interest.
  - perform with the highest sense of integrity.
  - be objective and independent, in fact and appearance.
  - exercise due care.

Exhibit 2.9: AICPA Code of Professional Conduct

Exhibit 2.9
Principles of Professional Conduct: AICPA Code of Professional Conduct
Responsibilities Principle: In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
The Public Interest Principle: Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
Integrity principle: To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
Objectivity and Independence Principle: A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
Due Care Principle: A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professionally responsibility to the best of the member's ability.
Scope and Nature of Services Principle: A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

Sarbanes–Oxley (SOX) Act

- Prompted by the audit failures of Enron, WorldCom, and others
- Key provisions:
  - Created the Public Company Accounting Oversight Board (PCAOB)
  - Requires management to certify financial statements
  - Imposes harsh penalties on management for violations

The Fraud Triangle

- **The Fraud Triangle** is a shape with three corners that represent the **elements** present when a fraud occurs, which are:
  1. The availability of an **opportunity**;
  2. Some form of **pressure** leading to an incentive to commit fraud; and
  3. The capacity for **rationalization** that the fraud will "right some type of wrong."

APPENDIX

LO 2-11: Compute depreciation expense and show how it affects financial statements.

Event 1: Purchase of Equipment

- On January 1, Year 1, Libby paid $43,000 cash to purchase a forklift.

Libby expected to rent the forklift to its customers during the coming four years and then to sell the used forklift for $3,000. The expected period of use is commonly called the **useful life.** The amount Libby expects to receive from the sale of the asset at the end of its useful life is called the **salvage value.**

Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Fork Lift	=	Unearned Revenue	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow	
(43,000)	+	43,000	=	n/a	+	n/a	+	n/a		n/a	−	n/a	=	n/a		(43,000)	IA

Event 2: Issuing a Promissory Note

- On February 1, Year 1, Libby borrowed $5,000 cash from the State Bank.

As evidence of the debt, Libby issues a promissory note that describes the company's obligations to the bank. The note stipulates a one-year term and an annual interest rate of 6 percent. Issuing the note is an asset source transaction. The asset account Cash increases and a new liability account called Notes Payable increases. The income statement is not affected.

Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Prepaid Rent	=	Notes Payable	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		Cash Flow	
5,000	+	n/a	=	5,000	+	n/a	+	n/a		n/a	–	n/a	=	n/a		5,000	FA

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Event 3: Rent Revenue

- During Year 1, Libby earned $16,000 cash by renting the forklift to its customers.

Assets			=	Liab.	+	Stockholders' Equity										Cash Flow	
Cash	+	Prepaid Rent	=	Notes Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		Cash Flow	
16,000	+	n/a	=	n/a	+	n/a	+	16,000		16,000	−	n/a	=	16,000		16,000	OA

Event 4: Estimating Straight-Line Depreciation

- On December 31, Year 1, Libby adjusts its accounts to recognize the expense of using the forklift during Year 1.
- (Asset cost – Salvage Value) ÷ Useful Life = **Depreciation Expense**
- (\$43,000 – \$3,000) ÷ 4 years = **\$10,000/year Straight-line Depreciation**

The asset account, Forklift, is not decreased directly as a result of depreciation. Instead, the asset reduction is recorded in a contra asset account called **Accumulated Depreciation**.

Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Accum. Deprec.	=	Notes Payable	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		Cash Flow
n/a	+	(10,000)	=	n/a	+	n/a	+	(10,000)		n/a	–	10,000	=	(10,000)		n/a

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Book Value

Forklift	$43,000
Accumulated Depreciation	(10,000)
Book Value (Also called **Carrying Value**)	$33,000

LO 2-12: Compute interest expense and show how it affects financial statements.

Event 6: Accrue Interest Payable

- On December 31, Year 1, Libby adjusts its books to recognize the amount of interest expense incurred during Year 1. (This transaction is a **Claims Exchange**.)
- Recall that Libby borrowed $5,000 on February 1, Year 1.
- As a result, Libby owes the bank interest for the 11 months the loan was outstanding during the year. The accrued interest is **$275 ($5,000 × .06 × 11/12).**

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Fork Lift	=	Interest Payable	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income	Cash Flow
n/a	+	n/a	=	275	+	(275)	+	n/a		n/a	−	275	=	(275)	n/a

Exhibit 2.11: Summarized Events for Libby in Year 1

	Assets			=	Liab.		+	Equity	
	Cash	+	Fork Lift	=	Notes Payable	Interest Payable	+	Ret. Earn.	Other Account Titles
Event									
Beginning Balance	$43,000		$ 0		$ 0	$0		$43,000	
1. Purchase fork lift	(43,000)		43,000						
2. Borrowed Cash	5,000				5,000				
3. Recognize Revenue	16,000							16,000	Revenue
4. Recognize depreciation			(10,000)					(10,000)	Depreciation Expense
5. Accrued Interest						275		(275)	Interest Expense
Ending Balance	$ 21,000	+	$33,000	=	$ 5,000	$ 275	+	$ 48,725	

Accounting Events for Year 2

1. Recognize Interest Expense

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Fork Lift	=	Interest Payable	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income	Cash Flow	
n/a	+	n/a	=	25	+	n/a	+	(25)	n/a	−	25	=	(25)	n/a	

2. Cash Payment for Interest Payable

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Fork Lift	=	Interest Payable	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income	Cash Flow	
(300)	+	n/a	=	(300)	+	n/a	+	n/a	n/a	−	n/a	=	n/a	(300)	OA

3. Repaying the Principal

Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Fork Lift	=	Note Payable	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income	Cash Flow	
(5,000)	+	n/a	=	(5,000)	+	n/a	+	n/a	n/a	−	n/a	=	n/a	(5,000)	FA

Libby's Financial Statements for Years 1 & 2

CATO CONSULTANTS		
Financial Statements		
December 31, Year 1 and 2		
Income Statement		
	Year 1	Year 2
Revenue	$ 84,000	$ 106,900
Depreciation Expense	(18,000)	(67,650)
Net Income	$ 66,000	$ 39,250
Statement of Changes in Stockholders' Equity		
	Year 1	Year 2
Beginning Common Stock	$ 0	$ 5,000
Plus: Common Stock Issued	5,000	2,000
Ending Common Stock	5,000	7,000
Beginning Retained Earnings	0	66,000
Plus: Net Income	66,000	39,250
Less: Dividends	0	(21,000)
Ending Retained Earnings	66,000	84,250
Total Stockholders' Equity	$ 71,000	$ 91,250
Balance Sheets		
Assets	Year 1	Year 2
Cash	$ 53,000	$ 9,300
Accounts Receivable	24,000	15,400
Supplies	0	150
Prepaid Rent	0	2,000
Land	0	79,500
Total Assets	$77,000	$ 106,350
Liabilities		
Accounts Payable	$0	$ 3,600
Unearned Revenue	0	7,500
Salaries Payable	6,000	4,000
Total Liabilities	6,000	15,100
Stockholders' Equity		
Common Stock	5,000	7,000
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End of Chapter 2