

1 An Introduction to Accounting



Learning Objectives

After studying lesson 1, you should be able to:

1. *Understand an information system of accounting*
2. *Apply conceptual framework*
3. *Understand financial statements*
4. *Use these accounting elements*
5. *Use the accounting equation*
6. *Understand accounting and its environment*

This lesson discusses how accounting information is needed by various users. Various entities that affect the accounting profession are mentioned. The role of ethics and standards of professional conduct in accounting is presented. The Conceptual framework is introduced.

Then the lesson introduces the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$. Each element of the equation is defined. Examples of a variety of transactions are analyzed and their impact on the accounting equation is discussed. The financial statements are illustrated.

1.1 Accounting is an Information System

Accounting is often described as an information system. It is the system that measures business activities, processes information into reports and communicates these findings to decision makers. The scope of accounting includes first identifying economic events, then

measuring, recording, summarizing, and reporting the information to users. Accounting covers a broader scope of activities than bookkeeping. Exhibit 1-1 presents the flow of information in an accounting system. **Bookkeeping** is only the part of accounting that records transactions and events. Accounting includes the analysis and interpretation of accounting information intended to be used by both external and internal users in making economic decisions.

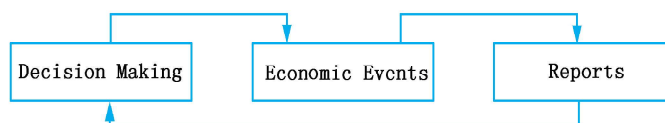


Exhibit 1-1

The primary **users of accounting information** are investors and creditors, government, labour unions, and the general public also use accounting information.

1.2 Forms of Organization

There are three forms of business organization:

A sole (single) proprietorship is a business organization that is owned by one individual. It is an accounting entity but not a legal entity. This means that the owner is responsible for the debts of the proprietorship. It is known as unlimited liability and is obviously a disadvantage of this form of business organization.

A partnership only differs from a single proprietorship in that it has more than one owner. The owners are called partners. There are some different types of partnerships in business activity.

A corporation is incorporated under local law as a separate entity; hence, its owners are called shareholders or stockholders. They are not liable for the debts of the corporation. The limited liability is an obvious advantage of the form. The ownership of a corporation is divided into shares or stock. Shares can be transferred between owners.

1.3 The Framework for the Preparation and Presentation of Financial Statements

It is the differences between national accounting models that have created the need for a harmonization of accounting standards; a global accounting language for the communication of relevant and reliable financial information.

In response to this growing need, the International Accounting Standards Committee (IASC) was founded in 1973 and has engaged in internationally recognized standard-setting to achieve this goal. On April 1, 2001, the IASC was restructured into the International Accounting Standards Board (IASB).

Exhibit 1-2 is an illustration of the structure, reproduced from the IASB website.

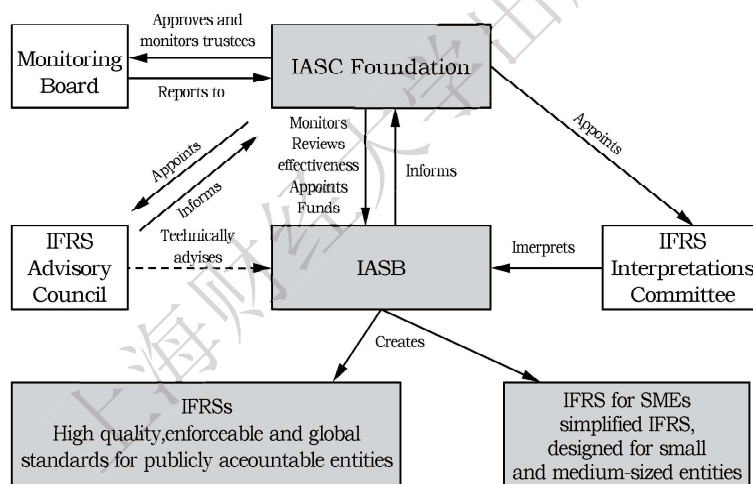


Exhibit 1-2 An Illustration of the Structure of IASB

The two underlying assumptions inherent in financial statements are

- (1) that the accounting information was prepared using the accrual basis, and
- (2) that the entity is assumed to be a going concern and will therefore continue operating into the future.

The qualitative characteristics of financial statements make the information useful to users. The Framework identifies four principal characteristics;

- understandability

- relevance
- reliability
- comparability

When all of the qualitative characteristics cannot be satisfied, a balance must be achieved based on the exercise of sound judgment. The result is a true and fair view or fair presentation of the financial information of the entity.

On February 15, 2006, the Ministry of Finance of the People's Republic of China formally announced the issuance of the long awaited Accounting Standards for Business Enterprises which consist of a new Basic Standard and 38 Specific ASBEs (Accounting Standards for Business Enterprises) and issued three more in 2014. During 2017 to now, China issued new accounting standard: non-current assets held for sale, disposal groups and discontinued Operations. Revised and issued new accounting standards related with financial instruments, government grants, revenue, lease, non-monetary assets exchange, debt restructurings accounting standards. Till now, we have 42 specific accounting standards. These standards are substantially in line with IFRSs, except for certain modifications which reflect China's unique circumstances and environment.

1.4 Understanding of Financial Statements

Accounting information must meet the needs of the users. The primary users are interested in financial information to evaluate profitability and solvency. Financial statements are final product of the accounting process. They should be presented in a good manner and be used to fulfill the objective of accounting — to provide information for decision making.

Four financial statements are prepared by a *proprietorship*:

- ▶ **Income statement.**
- ▶ **Statement of owner's equity** (also known as the **capital statement, statement of Changes in equity** in the further lessons).
- ▶ **Balance Sheet.**
- ▶ **Statement of cash flows.**

❖ **Balance Sheet (Statement of Financial Position)**

The **balance sheet** lists all assets, liabilities, and owner's equity as of a specific

date of an business entity. The balance sheet shows that assets equal the sum of liabilities and owner's equity.

The IASB's Framework defines an asset as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Assets can either be **tangible** or **intangible**. Examples of tangible assets include cash, accounts receivable, merchandise inventory, supplies, equipment, buildings, and machines. Examples of intangible assets are patents, trademarks and copyrights.

There are two sources of assets. One source is liabilities and the other is equity. The IASB's Framework defines a liability as follows:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Examples of liabilities include accounts payable, notes payable, salaries payable, taxes payable, interest payable, and bonds payable.

Equity (or Owner's equity for a sole proprietorship and also simply capital, partners' equity for a partnership, Shareholders' equity for a corporation) is a residual amount. The IASB's Framework defines equity as follows:

Equity is the residual interest in the assets that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Owner's equity represents the claims of owner(s) after creditors make claims from total assets. Owner's equity is sometimes referred to as net assets.

❖ **Income Statement (Statement of Financial Performance)**

The **income statement** lists revenues and expenses and shows net income or net loss for a period of time, such as a month, or a year. Net income or loss can be determined by the following formula:

$$\text{Net Profit (Net income Net loss)} = \text{Income} - \text{Expenses}$$

The IASB's Framework defines income as follows:

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. The definition of income encompasses both revenue and gains, and revenue arises in the course of ordinary activities of

an enterprise and is referred to by different names, such as sales, fees, interest, dividends, royalties, and rent.

IFRS 15 is the standard that details the accounting for revenue. In short, revenues are inflows of cash or other properties in exchange for goods or services provided to customers as part of the central operations of the business. Examples of revenues include sales, rents earned, dividends received, and interest earned. Do not confuse “income” with “net income.” Net income is the amount remaining after deducting expenses from income (or revenues).

The IASB’s Framework defines expenses as follows:

Expenses are decreases in economic benefits during an accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

❖ Statement of Owner’s Equity / Statement of Retained Earnings

The **statement of owner’s equity** shows the changes take place in the owner’s capital during a period of time from net income or net loss, withdrawals, and owner’s investment for a proprietorship.

A corporation prepares the **statement of retained earnings** to describe the changes in the retained earnings. It is part of changes in share-holders’ equity for a corporation.

Although the financial statements are very similar for the three types of business organizations discussed (sole proprietorship, partnership, and corporation), there are differences. These differences are summarized below in Exhibit 1–3.

Exhibit 1–3

Difference	Type of Business Organization		
	Sole Proprietorship	Partnership	Corporation
Equity section on the balance sheet is called:	Owner’s equity	Partners’ equity	Shareholders’ equity
Distributions to owners are called:	Withdrawals	Withdrawals	Dividends
When managers are also owners, their salaries are normally:	Not an expense *	Not an expense *	An expense

* This differs in some countries.

EXAMPLE 1-1 Preparation of the income statement, statement of owner's equity, and balance sheet

Amy Schneider, the owner of The Schneider's Accounting Firm, prepared the following income statement.

Amy Schneider, Accountant		
Income statement		
For the month ended December 31, 20××		
Revenues:		
Consulting revenue	\$ 3 800	
Rental revenue	<u>300</u>	
Total revenues		\$ 4 100
Operating expenses:		
Rent expense	\$ 1 000	
Salaries expense	<u>700</u>	
Total operating expenses		<u>1 700</u>
Net income		<u>\$ 2 400</u>

She then used the net income figure from the income statement to construct the statement of owner's equity.

Amy Schneider, Accountant		
Statement of Owner's Equity		
For the month ended December 31, 20××		
Amy Schneider, capital December 1, 20××		\$ 0
Investment during the month	\$ 30 000	
Add : net income	<u>2 400</u>	<u>32 400</u>
Less: withdrawals		\$ 600
Amy Schneider, capital December 31, 20××		<u>\$ 31 800</u>

Finally, Amy prepared the balance sheet at December 31 from the firm's records. She included in the balance sheet the December 31 capital balance from the statement of owner's equity.

Amy Schneider, Accountant			
Balance Sheet			
December 31, 20××			
Assets		Liabilities	
Cash	\$ 8 400	Accounts payable	\$ 200
Supplies	3 600	Notes payable	<u>6 000</u>
Furniture	<u>26 000</u>	Total liabilities	\$ 6 200
		Owner's equity	
		Amy Schneider, capital	<u>31 800</u>
Total assets	<u>\$ 38 000</u>	Total liabilities and capital	<u>\$ 38 000</u>

❖ Statement of Cash Flows

The **statement of cash flows** reports cash receipts and payments as well as cash inflows and outflows in three groups: operating activities, investing activities, and financing activities. The statement of cash flows will be explained in Lesson 10.

1.5 Accounting and its Profession

Accounting has a long history. Ancient accounting evidences were found in China, Babylonia, Greece, and Egypt. In the fifteenth century, Luca Pacioli, an Italian, established a system of record keeping which came to be called “double entry”. Double-entry-system is the foundation of the modern accounting. During the eighteenth century, the Industrial Revolution brought many social and economic changes. The specialized field of cost accounting emerged to meet the need for the analysis of various costs and for recording techniques. In the nineteenth century, the growth of corporations speeded the development of accounting. More and more individuals and institutions looked to accountants to provide information about these enterprises. The development of corporation also created a new social need—the need for an independent audit to provide some assurance that management's financial representations were reliable. In the United States, American **Institute of Certified Public Accountants (AICPA)** is the largest professional organization of accountants, same as to **Chinese Institute of Certified Public Accountants (CICPA)** in Chi-

na. Computers have revolutionized accounting recently. We have outstanding software to help us quickly and easily. In summary, accounting has developed new concepts and techniques to meet the ever increasing needs for financial information.

Accounting practices are in three main fields — **financial accounting**, **managerial accounting**, and **tax accounting**. Please notice that this illustration does not include **not-for-profit accounting**, which is performed for hospitals, universities, and other not-for-profit agencies. Exhibit 1-4 provides a summary of the activities performed by accountants.

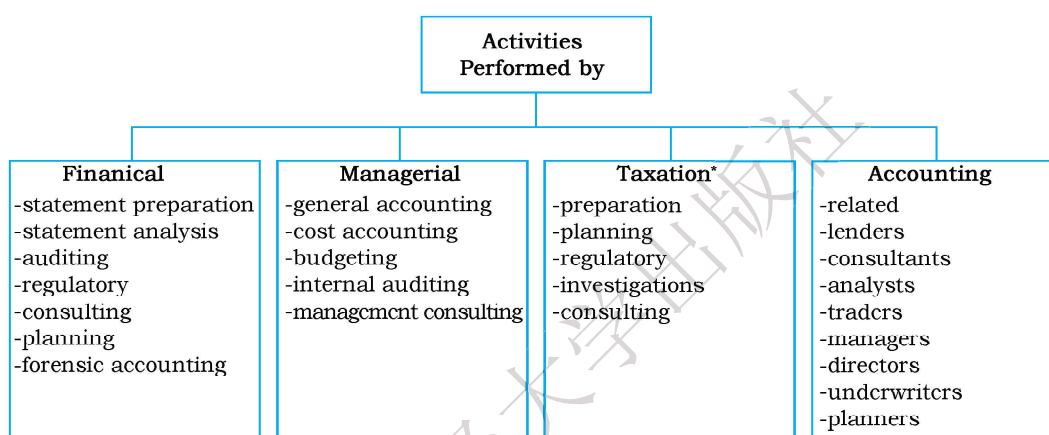


Exhibit 1-4

1.6 Accounting Elements and Using the Accounting Equation

❖ What is Accounting Equation

Accounting elements are basic classification of accounting practices. They are essential units to present the financial position and operating result of an entity. We were introduced to the balance sheet. The relationship between assets and the claims against the assets can be summarized in the following equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

A **business transaction** is an exchange of goods or services that affects this equation. It is essential to understand the effects of transactions on the accounting equation in order to understand the accounting function.

According to the income statement, we learned the relationship between revenue and expense:

$$\text{Net income (Net loss)} = \text{Revenues} - \text{Expenses}$$

Next net income or net loss will be closed to owner's equity. And we can have the following presentation of accounting equation.

$$\text{Assets} = \text{Liabilities} + [\text{Owner's equity} + (\text{Revenues} - \text{Expenses})]$$

❖ Effects of Transactions on the Accounting Equation

All business transactions, from the simplest to the most complex, can be stated in terms of the resulting change in the three basic elements of the accounting equation. The accounting equation applies to all economic and legal entities — from a proprietorship to large corporations. We must understand the following points:

1. Every transaction affects at least two items in the accounting equation (**double-entry accounting**).
2. The accounting equation remains in balance after each transaction.
3. Revenues and owner investments increase owner's equity. Expenses and owner withdrawals decrease owner's equity. Therefore, owner's equity is directly affected by revenues, expenses, investments, and withdrawals.

Example 1-2 following demonstrates how various transactions affect the accounting equation and then how those transactions are summarized and finally reported on the income statement, statement of owner's equity, and balance sheet.

EXAMPLE 1-2 Effects of transactions on the accounting equation and preparation of financial statements

Hilary Clapton, the owner of a professional practice, has the following events occurred during her first month of operations.

- A. Hilary invested \$ 50 000 cash into the business. She also invested \$ 10,000 equipment.
- B. She paid rent \$ 1 600 for the month.
- C. She purchased \$ 12 000 equipment on account.
- D. She earned \$ 2 000 revenue and received the cash.
- E. She earned \$ 7 000 revenue on account.
- F. She paid \$ 8 000 cash to purchase equipment.
- G. She paid the \$ 2 400 cash for salary.

H. She collected \$ 5 000 from her client (see Transaction E).

I. She paid \$ 12 000 cash for her account owed (see Transaction C).

J. She withdrew \$ 500 cash for her personal use.

Please calculate net income earning during the first month;

Solution:

Assets			=	Liabilities + Owner's Equity		
Cash	Accounts receivable	Equipment		Accounts payable	Linda Champion, capital	Explanation of change in equity
A \$ 50 000		\$ 10 000			\$ 60 000	Investment
B -1 600					-1 600	Expense
C		+12 000		+12 000		
D +2 000					+2 000	Revenue
E	+7 000				+7 000	Revenue
F -8 000		+8 000				
G -2 400					-2 400	Expense
H +5 000	-5 000					
I -12 000				-12 000		
J -500					-500	Withdrawal
<u>32 500</u>	<u>2 000</u>	<u>30 000</u>		<u>0</u>	<u>64 500</u>	

$$\$ 64\,500 = \$ 64\,500$$

Net income = Revenues - Expenses

$$= (\$ 2\,000 + \$ 7\,000) - (\$ 1\,600 + \$ 2\,400)$$

$$= \$ 5\,000$$

Based on the summary of transactions in the form above, we can prepare the financial statements except cash flow statement:

Hilary Clapton Income Statement For month ended May, 20xx		
Service revenue		\$ 9 000
Expenses:		
Rent expense	\$ 1 600	
Salary expense	2 400	
Total expenses		4 000
Net income		<u>\$ 5 000</u>

Hilary Clapton Statement of Owner's Equity For month ended May, 20××	
Hilary Clapton capital, May 1	\$ 0
Add: Investments by owner	60 000
Net income	5 000
Less: Withdrawals by owner	(500)
Hilary Clapton, capital, May 31	<u>\$ 64 500</u>

Hilary Clapton Balance Sheet May 31, 20××			
Assets		Liabilities	
Cash	\$ 32 500	--	0
Accounts Receivable	2 000		
Equipment	30 000		
		Owner's equity	
		Hilary Clapton, capital	64 500
Total assets	<u>\$ 64 500</u>	Total liabilities and capital	<u>\$ 64 500</u>

1.7 Ethics in Accounting

Ethics is essentially the study of right and wrong, and has been a prominent and sensitive issue in the accounting profession for years.

Ethical codes serve as a foundation for developing ethical behaviour in professions. They also provide a framework for ethical practice. However, codes alone are not enough and can never serve as the final moral authority. An overemphasis on codes would eliminate criticism of the codes from a broader moral framework. What is needed is *moral character and ethical reasoning ability*. In recent years there has been widespread interest in accounting ethics, due partly to wide media coverage of events involving a host of misdeeds, such as insider trading, tax evasion, audit failure, and fraud. Reports of unethical behaviour are a threat to public confidence in the accounting profession.

❖ Some Basic Ethical Standards

A full explanation of ethical standards in accounting is beyond the scope of this intro-

ductory course. However, it is not too early to introduce some basic ethical standards that are expected of professional accountants. Four key standards are below:

Integrity. Accountants have responsibility to report favourable as well as unfavourable information and to refrain from taking actions which undermine an organization's legitimate and ethical objectives. Integrity implies that accountants should not take unfair advantage of information and should act in the interests not only of their clients but of other indirect users. Accountants should also disassociate themselves from any attempts to disclose misleading information.

Confidentiality. Accountants have a duty to refrain from disclosing confidential information unless legally obligated to do so. The work of the accountant regularly involves dealing with confidential files about the personal and business affairs of their clients. Decisions made on information provided by accountants can materially affect the lives of clients and others, often referred to as third parties, which include employees, creditors, investors, suppliers, customers, government, and the general public.

Competence. Accountants have a duty to perform their professional duties according to high standards and to ensure that they stay current with changes in the profession. Users of accounting information may not have accounting expertise. Thus, members of the accounting profession enjoy a position of power. To be worthy of user confidence, accountants must not abuse this power and must act according to a high ethical standard. Accountants have an ethical obligation to maintain both technical competence and moral competence.

Objectivity. Accountants must fully disclose all relevant information that assists users to understand financial reports. Business, governments, and the public at large depend on the accounting profession to provide fair financial reporting and business advisory services. Accountants, therefore, are obligated to provide information that is objective so that users can rely on its accuracy when making investment and credit decisions.

Vocabulary

Accounting	(会计)
Bookkeeping	(簿记)
A proprietorship	(独资)
A partnership	(合伙)
A corporation	(公司)

International Accounting Standards Board (IASB)	(国际会计准则理事会)
International Financial Reporting Standards (IFRSs)	(国际财务报告准则)
Income statement/Statement of financial performance	(利润表)
Statement of changes in equity	(所有者权益变动表)
Balance sheet/Statement of financial position	(资产负债表)
Statement of cash flows	(现金流量表)
Asset	(资产)
Liability	(负债)
Owner's equity/Capital	(所有者权益)
Expense	(费用)
Income	(收益)
Accrual basis	(应计制/权责发生制)
Going-concern	(持续经营)
Understandability	(可理解性)
Relevance	(相关性)
Reliability	(可靠性)
Comparability	(可比性)
Double-entry system	(复式记账)
American Institute of Certified Public Accountants (AICPA)	(美国注册会计师协会)
Chinese Institute of Certified Public Accountants (CICPA)	(中国注册会计师协会)
Financial accounting	(财务会计)
Managerial accounting	(管理会计)
Tax accounting	(税务会计)
Accounting equation	(会计等式)
Business transaction	(经济业务)
Ethics of accounting	(会计职业道德)

Self-Test Questions

Answer of these questions appears at the end of lesson cases.

- The primary objective of financial reporting is _____.
 - to present information in an ethical manner
 - to provide information to the federal government
 - to provide information useful for investment and lending decisions
 - to provide information useful to managers in making daily decisions
- The principle or concept that holds that an entity will remain in operation for the foreseeable future is the _____.

- A. going-concern concept
 - B. stable-monetary-unit concept
 - C. reliability principle
 - D. cost principle
3. Which of the following statements is true? ____.
- A. Revenues are assets because they represent economic benefits
 - B. Assets are economic resources that are expected to benefit future periods
 - C. The accounting equation can be stated as Assets + Liabilities = Owner's Equity
 - D. Liabilities are economic obligations to insiders
4. If assets increase \$ 80 000 during the period and owners' equity decreases \$ 16 000 during the period, liabilities must have ____.
- A. increased \$ 64 000
 - B. increased \$ 96 000
 - C. decreased \$ 64 000
 - D. decreased \$ 96 000
5. The amount of net income shown on the income statement also appears on the ____.
- A. statement of financial position
 - B. balance sheet
 - C. statement of owner's equity
 - D. statement of cash flows

Discussion Questions

1. What do we mean when we say that accounting is a means rather than an end?
2. What is the primary distinction between financial accounting and managerial accounting?
3. What is an accounting system and what is the primary objective of such a system?
4. What are the three primary financial statements with which we communicate financial accounting information?
5. What is meant by GAAP, and how do these principles add to the integrity of financial accounting information?

Exercises

Exercise 1-1

The following selected transactions were completed by Castell Delivery Service during November:

- (1) Received cash from owner as additional investment, \$ 20 000.
- (2) Paid advertising expense, \$ 520.
- (3) Purchased supplies of gas and oil for cash \$ 780.
- (4) Received cash from cash customers, \$ 1 500
- (5) Charged customers for delivery services on account, \$ 2 100.
- (6) Paid creditors on account, \$ 470.
- (7) Paid rent for November, \$ 1 000
- (8) Received cash from customers on account, \$ 1 810.
- (9) Paid cash to owner for personal use, \$ 900.
- (10) Determined by taking an inventory that \$ 650 of supplies of gas and oil had been used during the month.

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

- (a) Increase in one asset, decrease in another asset.
- (b) Increase in an asset, increase in a liability.
- (c) Increase in an asset, increase in capital.
- (d) Decrease in an asset, decrease in a liability.
- (e) Decrease in an asset, decrease in capital.

Exercise 1-2

C. F. Sirmans is engaged in a service business. Summary financial data for October are presented in equation form as follows. Each Lynne designated by a number indicates the effect of a transaction on the equation. Each increase and decrease in capital, except transaction (5), affects net income.

	Cash	+	Supplies	+	Land	=	Liabilities	+	Capital
Bal.	12 000		540		4 000		1 540		15 000
(1)	-6 000				+6 000				
(2)	+3 200								+3 200
(3)	-1 200								-1 200
(4)			+800				+800		
(5)	-750								-750
(6)	-1 500						-1 500		
(7)			-630						-630
Bal.	<u>5 750</u>		<u>710</u>		<u>10 000</u>		<u>840</u>		<u>15 620</u>

- Describe each transaction.
- What is the amount of net decrease in cash during the month?
- What is the amount of net increase in capital during the month?
- What is the amount of the net income for the month?
- How much of the net income of the month was retained in the business?

Exercise 1-3

Financial information related to the sole proprietorship of Tina Pierce Interiors for March and April of the current year is as follows:

	March 31	April 30
	19--	19--
Accounts Payable.....	\$ 430	\$ 690
Accounts Receivable.....	2 560	4 100
Tina Pierce, Capital.....	?	?
Cash.....	4 500	5 400
Supplies.....	840	450

- Prepare balance sheets for Tina Pierce Interiors as of March 31 and as of April 30 of the current year.
- Determine the amount of net income for April, assuming that the owner had made no additional investments or withdrawals during the month.
- Determine the amount of net income for April, assuming that the owner had made no additional investments and had withdrawn \$ 2 500 during the month.

Problems

Problem 1-1

On August 1 of the current year C. W. CollYnns established a sole proprietorship under the name CollYnns Realty. CollYnns completed the following transactions during the month:

- (a) Opened a business bank account with a deposit of \$ 5 000.
- (b) Paid rent on office and equipment for the month, \$ 1 200.
- (c) Purchased supplies (stationery, stamps, pencils, ink, etc.) on account, \$ 340.
- (d) Paid creditor on account, \$ 250.
- (e) Earned sales commissions, receiving cash, \$ 4 850.
- (f) Withdrew cash for personal use, \$ 1 000.
- (g) Paid automobile expenses (including rental charge) for month, \$ 280, and miscellaneous expenses, \$ 175.
- (h) Paid office salaries, \$ 600.
- (i) Determined that the cost of supplies used was \$ 65.

Required:

- (1) Record the transactions and the balances after each transaction, using the following tabular headings:

<u>Assets</u>		<u>Liabilities</u>		<u>Capital</u>
		Accounts		C. W. CollYnns,
Cash+Supplies	=	Payable	+	Capital

By appropriate notations at the right of each change, indicate the nature of each increase and decrease in capital subsequent to the initial investment.

- (2) Prepare an income statement for August, a capital statement for August, and a balance sheet as of August 31.

Problem 1-2

Following are the amounts of the assets and liabilities of Pioneer Services, a sole proprietorship, on December 31, the *end* of the current year, and its revenue and expenses for

the year ended on that date. The capital of E. G. Eberhart, owner, was \$ 10 655 on January 1, the *beginning* of the current year, and the owner withdrew \$ 25 000 during the current year.

Cash	\$ 6 150
Accounts receivable	12 260
Supplies	1 200
Prepaid insurance	400
Accounts payable	4 010
Salary payable	2 100
Sales	91 670
Salary expense	25 200
Rent expense	8 000
Utilities expense	7 800
Supplies expense	6 200
Taxes expense	6 000
Insurance expense	4 800
Advertising expense	3 000
Miscellaneous expense	2 425

Required:

- (1) Prepare an income statement for the current year ending December 31, exercising care to include each item of expense.
- (2) Prepare a capital statement for the current year ending December 31.
- (3) Prepare a balance sheet as of December 31 of the current year.

Problem 1–3

On March 1 of the current year, Express Delivery, Inc. was organized as a corporation. The summarized transactions of the business for its first two months of operation, ending on April 30, are as follows:

- (a) Received cash from stockholders for capital stock \$ 50 000
- (b) Purchased a portion of a delivery service that had been operating as a partnership in accordance with the following details:

Accounts receivable	\$ 12 400	
Truck supplies	3 810	
Office supplies	<u>960</u>	\$ 17 170
Liabilities assumed by the corporation:		
Accounts payable		8 670
Payment to be made as follows:		
Cash		\$ 2 500
Three non-interest-bearing notes payable of		
\$ 2 000 each, due at two-month intervals	<u>6 000</u>	<u>\$ 8 500</u>
(c) Purchased truck supplies on account		\$ 1 615
(d) Paid creditors on account		5 280
(e) Purchased office supplies for cash		120
(f) Paid insurance premiums in advance		600
(g) Received cash from customers on account		8 690
(h) Paid advertising expense		1 100
(i) Paid first of the three notes payable		2 000
(j) Charged delivery service sales to customers on account		30 550
(k) Paid rent expense on office and trucks		3 025
(l) Paid utilities expense		840
(m) Paid miscellaneous expenses		1 475
(n) Paid wages expense		16 600
(o) Paid taxes expense		220
(p) Truck supplies used		2 680
(q) Office supplies used		340
(r) Insurance premium that expired and became an expense		200
(s) Purchased land as future building site, paying \$ 8 000 cash and giving a note payable due in 5 years for the balance of \$ 20 000		28 000
(t) Paid cash dividends to stockholders		750

Required:

- (1) List the following captions in a single Lynne at the top of a sheet turned sideways

$$\begin{array}{ccccccccc}
 & & \text{Accounts} & & \text{Truck} & & \text{Office} & & \text{Prepaid} \\
 & & \text{Receivable} & + & \text{Supplies} & + & \text{Supplies} & + & \text{Insurance} \\
 \text{Cash} & + & & & & & & & \\
 & + & \text{Land} & = & \text{Notes} & + & \text{Accounts} & + & \text{Capital} & + & \text{Retained} \\
 & & & & \text{Payable} & & \text{Payable} & & \text{Stock} & & \text{Earnings}
 \end{array}$$

(2) Record the original investment in the corporation and the remaining transactions in the appropriate columns, identifying each by letter. Indicate increases by + and decreases by – **Do not determine the new balances of the items after each transaction.** In the space for retained earnings notations, identify each revenue and expense item and dividends paid to stockholders.

(3) Insert the final balances in each column and determine that the equation is in balance at April 30, the end of the period.

(4) Prepare the following: (a) income statement for the two months, (b) retained earnings statement for the two months, and (c) balance sheet as of April 30.

Answers to Self-Test Questions:

1. c 2. a 3. b 4. b 5. c

2 Recording Transactions



Learning Objectives

After studying lesson 2, you should be able to:

1. *Understand economic events and business documents*
2. *Understand T accounts and debit & credit*
3. *Journalize and post transactions*
4. *Prepare a trial balance*
5. *Use the information—the debt ratio*

Lesson 1 discusses that accounting provides useful financial information for decision makers. To generate the information, a business uses an accounting process that analyzes economic events, records the results, and classifies and summarizes the information in reports and financial statements.

2.1 Economic Events and Business Documents

This multi-step accounting process is summarized in a flowchart in Exhibit 2-1. The flowchart shows the process in which financial statements are derived from economic events. Economic events include both external and internal transactions.

- An **external transaction** is a completed exchange of economic consideration between an organization and one or more outside parties.
- An **internal transaction** is an economic event that has an effect on the accounting equation but does not involve an outside party.

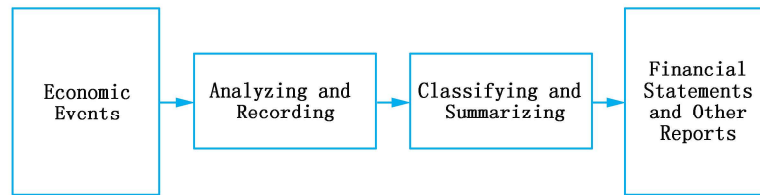


Exhibit 2-1

Not all events that have an effect on the organization are recorded as transactions. For instance, changes in market interest rates. The effect of an event must be reliably measured to be recorded as a transaction. A measure is reliable if the dollar amount of the event is reasonably free from error, bias, and is a faithful representation of the event. Users of financial statements expect accounting information to be reliable so that they can depend on it to make decisions.

Source documents, also known as business papers, provide evidence of transactions and are the basis for recording the transactions. Examples of source documents include checks, sales invoices, bank statements, purchase orders, customer bills, employee earnings records, and cash register tapes.

2.2 T Accounts and Debit & Credit

An account is a place or location within an accounting system in which the increases and decreases in a specific asset, liability, owner's equity, revenue or expense are recorded and stored. Accounts provide the economic foundation upon which the accounting system is built. These accounts are used to summarize financial transactions. We saw that the balances of these accounts flowed into financial statements—the income statement, the statement of owner's equity, and the balance sheet. Source documents provide much of the evidence of the accounting information that flows into the accounts from external events. We will learn in later lessons for many internal transactions, the linkage between source documents and the recording of economic events is not clearly defined. In such cases, the accountant must make assumptions and use judgment that requires changes to be made to the balances in some of the accounts at the end of each accounting period.

❖ Types of Accounts

Accounts are basic records that are used to show changes — both increases and decreases — in assets, liabilities, and owner's equity. A separate account is kept for each financial statement element. This enables accountants to effectively and accurately maintain accounting records.

The simplest form of an account has three parts: (1) a title, which is the name of the item recorded in the account; (2) a space for recording increases in the amount of the item, in the terms of money; (3) a space for recording decreases in the amount of the item, also in monetary terms. Transactions are entered in T accounts as follows:

1. Decreases in an account are entered on one side of the T, and increases are entered on the other side.
2. The account balance is determined by subtracting the total decreases from the total increases. This form of an account, illustrated below, is known as a T account because of its similarity to the letter T.



Exhibit 2-2

When deciding what type of account is affected by a transaction and whether a debit or credit is required, it is helpful to group accounts into six categories — assets, liabilities, owner's capital, revenues, expenses, and owner's withdrawals.

► Asset accounts

Asset accounts carry their balances forward from one period to the next. Examples of asset accounts include Cash (on hand and in bank), Receivables, Prepaid expenses (insurance, rent, taxes, office supplies), Equipment, Buildings, and Land. The left side of asset accounts is used for recording increases and the right side is used for recording decreases.

► Liability accounts (the equity of creditors)

Liability accounts also carry their balances forward from one period to the next. Examples of liability accounts are Payables, Unearned revenues (subscriptions, rent, legal

fees), and Other liabilities (wages, taxes, interest). The right side of liability accounts is used for recording increases and naturally the left side is used for recording decreases.

► Owner's equity account

The balance in the owner's equity account carries forward to the next accounting period. A separate account is employed for each item affecting owner's equity — investments, withdrawals, revenues, and expenses.

Capital account

For a proprietorship, a capital account is used to record the original investment and any permanent additional increases or decreases in owner's equity. The right side of capital accounts is used for recording increases and naturally the left side is used for recording decreases.

Withdrawals account

A withdrawals account (also known as a personal account or drawing account) is *not* a salary or an expense of the business. Owner's withdrawals of earnings or anticipated earnings include withdrawals of cash (or other assets) to pay personal expenses. Withdrawals are a distribution of earnings rather than an expense. *Withdrawals are not recorded in the income statement.*

► Revenue and expense accounts

The income statement accounts have balances only during an accounting period. The balances in these accounts are not carried forward to the next accounting period. The theory of debit and credit in its application to revenue and expense accounts is based on the relationship between these accounts and capital. The net income or the net loss for a period, as reported on the income statement, is the net increase or the net decrease in capital resulting from operations.

Revenue increases capital. Just as increases in capital are recorded as credits, increases in revenues during an accounting period are recorded as credits. Expenses have the effect of decreasing capital, and just as decreases in capital are recorded as debits, increases in expense accounts are recorded as debits.

Periodically, usually at the end of the accounting year, all revenue and expense account balances are transferred to a summarizing account, and the accounts are then said to be closed. The balance in the summarizing account, which is the net income or net loss for the period, is then transferred to the capital account (to the retained earnings account for a corporation), and the summarizing account is also closed. Because of the periodic closing

of these accounts, they are sometimes called **temporary accounts** or **nominal accounts**. The balances of the accounts reported in the balance sheet are carried forward from year to year and are sometimes referred to as **real accounts because of their permanence**.

❖ Chart of Accounts and Ledger

A **chart of accounts** is a list of all accounts used in a company. Each account is identified by a name and a code number. Account names should be descriptive and clear. For example, *rent* is unclear. It could be an asset (Prepaid rent), a liability (Unearned rent), a revenue (Rent earned), or an expense account (Rent expense). Account numbers are assigned according to a pre-established system. These model charts are for a small business using a three-digit account numbering system. More complex businesses use four, five, or more digits as account numbers. The account number can also identify whether an account appears on the balance sheet or the income statement.

The following is an simple example of a chart of accounts of Sara Cole's.

Chart of Accounts

Balance Sheet Accounts

1. Assets
 - 11 Cash
 - 12 Accounts Receivable
 - 14 Supplies
 - 15 Prepaid Rent
 - 18 Photographic Equipment
 - 19 Accumulated Depreciation
2. Liabilities
 - 21 Accounts Payable
 - 22 Salaries Payable
3. Capital
 - 31 Sara Cole, Capital
 - 32 Sara Cole, withdrawals
 - 33 Income Summary

Income Statement Accounts

4. Revenue
 - 41 Sales
5. Expenses
 - 51 Supplies Expense
 - 52 Salary Expense
 - 53 Rent Expense
 - 54 Depreciation Expense
 - 59 Miscellaneous Expense

The purpose of a chart of accounts is to help us set up the general ledger. The term ledger refers to a collection of all the company's accounts. The preparation of the balance sheet and the income statement is facilitated by referring to the financial information contained in the **general ledger**.

❖ The Accounting Equation and the Rules of Debits and Credits

Note that every transaction affects and is recorded in two or more accounts with equal debits and credits. The debits in the ledger must equal the credits.

The accounting equation introduced in Lesson 1:

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

It provides the basis for debit-credit rules. Increases in assets are recorded on the left side of asset accounts. The increase side is always on the same side that the account appears in the equation — that is, increases in assets are on the left side, while increases in liabilities or owner's equity are on the right side. The rules of debit and credit can be depicted with Taccounts, as follows:

Assets		=	Liabilities		+	Owner's equity	
Debit for increases	Credit for decreases		Debit for decreases	Credit for increases		Debit for decreases	Credit for increases

❖ Normal Balances

The **normal balance** of each type of account is a debit or credit balance depending on which side of the account is used to record increases. The balance side (normal balance) is on the same side that the account appears in the accounting equation. Since assets appear on the left side of the equation, the balance side for assets is on the left side (debit side). Since liabilities and owner's equity accounts appear on the right side of the accounting equation, the increase side for these accounts is on the right side (credits).

2.3 Journalizing and Posting Transactions

The sequence of the principal accounting procedures of a fiscal period is frequently called the accounting cycle.

It begins with the analysis and journalizing of transactions and ends with the post-closing trial balance. Financial statements are the most significant outputs of the accounting cycle. The various steps have been arbitrarily divided into three stages: steps occurring throughout the year, at the end of the year, and at the beginning of the next year. The ac-

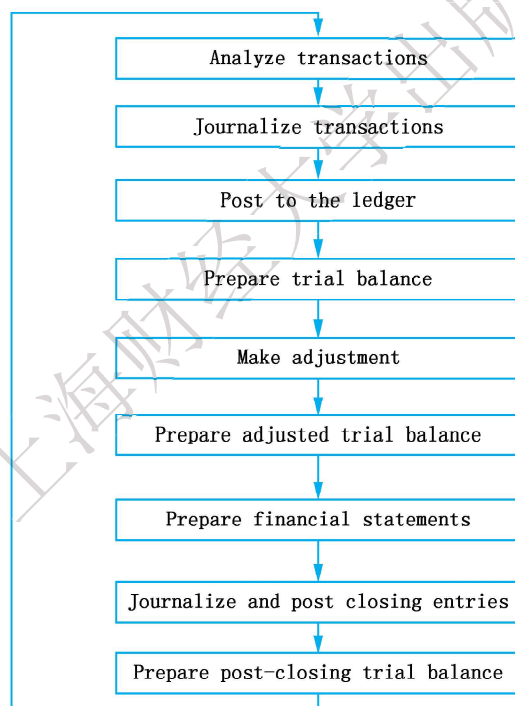
counting cycle is presented in a flowchart in Exhibit 2-3.

Transaction analysis is the first step in the accounting cycle. We need to perform this step before we can record a firm's economic events. To analyze transactions, follow this procedure:

1. Determine the types of accounts affected (asset, liability, owner's capital, revenue, expense, owner's withdrawals).
2. Determine which accounts increase/decrease as a result of the transaction.
3. Convert the increase/decrease to debits and credits.

It is also important to master the rules of debit and credit — the terms *debit* and *credit* should not be confused with *increase* and *decrease*.

Exhibit 2-3 The accounting cycle



EXAMPLE 2-1 Analyzing transactions using T accounts

a. Steve Moore invested \$ 12 750 cash in the business:

Cash	Steve Moore, Capital
(a) 12 750	(a) 12 750

b. Purchased \$ 375 of office supplies for cash:

Office Supplies	Cash
(b) 375	(a) 12 750 (b) 375

c. Purchased \$ 7 050 of office equipment on credit:

Office Equipment	Accounts Payable
(c) 7 050	(c) 7 050

d. Received \$ 1 500 cash as fees for services provided to a customer:

Cash	Fees Earned
(a) 12 750 (b) 375 (d) 1 500	(d) 1 500

e. Paid for the office equipment purchased in transaction c:

Accounts Payable	Cash
(e) 7 050 (c) 7 050	(a) 12 750 (b) 375 (d) 1 500 (e) 7 050

f. Billed a customer \$ 2 700 as fees for services:

Accounts Receivable	Fees Earned
(f) 2 700	(d) 1 500 (f) 2 700

g. Paid the monthly rent with \$ 525 cash:

Rent Expense	Cash
(g) 525	(a) 12 750 (b) 375 (d) 1 500 (e) 7 050 (g) 525

h. Collected \$ 1 125 of the account receivable created in transaction (f) :

Cash		Accounts Receivable	
(a) 12 750	(b) 375	(f) 2 700	(h) 1 125
(d) 1 500	(e) 7 050		
(h) 1 125	(g) 525		

i. Steve Moore withdrew \$ 1 000 cash from the business :

Steve Moore, Withdrawals	Cash	
(i) 1 000	(a) 12 750	(b) 375
	(d) 1 500	(e) 7 050
	(h) 1 125	(g) 525
		(i) 1 000

❖ Journalizing Transactions

The first step in the accounting cycle is analyzing transactions. The next formal step in the processing of financial statements is recording the transactions in a journal, or **journalizing**. Then we will learn the practice of journalizing and posting transactions.

A journal entry can be seen as an instruction to change the balance of accounts. All transactions involve at least two accounts. When more than two accounts are affected, it is called a **compound journal entry**.

The two-column journal, which is still widely used, serves as a valuable device in analyzing transactions. The standard form of the two-column journal is illustrated as follows in exhibit 2-4:

Exhibit 2-4

Journal			Page 1		
Date		Account titles and explanation	Post. Ref.	Debit	Credit
Dec.	1	Cash		12 000	
		××, Capital			12 000
		<i>The investment of the owner</i>			
	2	Rent expense		500	
		Insurance expense		500	
		Cash			1 000
		<i>Payment of rent and insurance</i>			

The **general journal** (or **journal**) is a book of original entry that links the debits and credits of individual transactions by providing a complete record of each transaction in one place, in chronological order. The debits and credits are copied from the journal to the book of final entry (the **general ledger** or **ledger**). This procedure is especially helpful in tracing debits and credits to accounts when an error is discovered.

Exhibit 2-4 shows the format of a general journal entry. Please note that the journal entry records these details about a transaction:

- ▶ the transaction date
- ▶ the names of the affected accounts
- ▶ the amount of each debit and credit
- ▶ an explanation of the transaction

EXAMPLE 2-2 General journal entries

In the start-up of Emily Schneider, a CPA, the following transactions for the month of December 20×× were recorded in the business's general journal:

- Dec. 1 She invested \$ 12 000 cash to start her business.
- Dec. 2 She paid rent of the month for \$ 500.
- Dec. 3 She purchased equipment for cash at \$ 3 000.
- Dec. 4 She purchased furniture on account at \$ 3 600.
- Dec. 5 She purchased supplies on account at \$ 300.
- Dec. 6 She earned service revenue for cash at \$ 800.
- Dec. 7 She paid the utilities for the month at \$ 200.
- Dec. 8 She earned credit revenue at \$ 1 700.

It should be noted that all transaction are recorded only in terms of debits and credits to specific accounts. The titles used in the entries should be the same as the titles of the accounts in the ledger. The line following an entry is left blank in order to clearly separate each entry. The column headed Post. Ref. (posting reference) is not used until the debits and credits are posted to the appropriate accounts in the ledger.

Journal			Page 1		
Date		Account titles and explanation	Post. Ref.	Debit	Credit
Dec.	1	Cash		12 000	
		Emily Schneider, Capital			12 000
		<i>The investment of the owner.</i>			
	2	Rent expense		500	
		Cash			500
		<i>The payment of the rent of the month.</i>			
	3	Equipment		3 000	
		Cash			3 000
		<i>The purchase of equipment for cash.</i>			
	4	Furniture		3 600	
		Accounts payable			3 600
		<i>The purchase of furniture on account.</i>			
	5	Supplies		300	
		Accounts payable			300
		<i>The purchase of supplies on account.</i>			
	6	Cash		800	
		Service revenue			800
		<i>The cash revenue of the month.</i>			
	7	Utilities expense		200	
		Cash			200
		<i>The payment of the utilities of the month.</i>			
	8	Accounts receivable		1 700	
		Service revenue			1 700
		<i>The credit revenue of the month.</i>			

❖ Posting Transactions

Posting is the process of copying journal entry information from the journal to the ledger. Cross-referencing account numbers and journal page numbers is necessary to avoid omission and duplication. This is done in the posting reference (PR or folio) column, where a letter is used to indicate which journal the posted entry came from. Notice that there is also a posting reference column in the general journal that is used to record the ledger account the transaction was posted to. The posting of journal entry to ledger is performed in the following steps:

1. Record the date and the amount of the entry in the account.
2. Insert the number of the journal page in the Posting Reference column of the account.
3. Insert the ledger account number in the Posting Reference column of the journal.

This referencing process will be illustrated in the **general journal** at the end of Example 2-4 following.

Example 2-3 makes use of the journal entries in Example 2-2 to demonstrate posting to the ledger using the balance column format. Notice that in Example 2-2, posting references are absent because the journal entries had not yet been posted.

EXAMPLE 2-3 Posting journal entries to the ledger

The following is the general ledger of Emily Schneider's accounting business after posting the journal entries in Example 2-2. Assume that all of the journal entries were recorded on Page 1 in the general journal (G1).

Cash		Acct. No. 101			
Date	Explanation	PR	Debit	Credit	Balance
20xx					
Dec. 1		G1	12 000		12 000
2		G1		500	11 500
3		G1		3 000	8 500
6		G1	800		9 300
7		G1		200	9 100

Accounts Receivable

Acct. No. 106

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 8		G1	1 700		1 700

Supplies

Acct. No. 124

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 5		G1	300		300

Equipment

Acct. No. 163

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 3		G1	3 000		3 000

Furniture

Acct. No. 165

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 4		G1	3 600		3 600

Accounts Payable

Acct. No. 210

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 4		G1		3 600	3 600
5		G1		300	3 900

Emily Schneider, Capital

Acct. No. 301

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 1		G1		12 000	12 000

Service Revenue

Acct. No. 401

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 6		G1		800	800
8		G1		1 700	2 500

Rent Expense

Acct. No. 610

Date	Explanation	PR	Debit	Credit	Balance
20xx Dec. 2		G1	500		500

Utilities Expense

Acct. No. 620

Date	Explanation	PR	Debit	Credit	Balance
20××					
Dec. 7		G1	200		200

After posting from the general journal to the general ledger, the general journal would include posting references as follows:

Journal			Page 1		
Date		Account titles and explanation	Post. Ref.	Debit	Credit
Dec.	1	Cash	101	12 000	
		Emily Schneider, Capital	301		12 000
		<i>The investment of the owner.</i>			
	2	Rent expense	610	500	
		Cash	101		500
		<i>The payment of the rent of the month.</i>			
	3	Equipment	163	3 000	
		Cash	101		3 000
		<i>The purchase of equipment for cash.</i>			
	4	Furniture	165	3 600	
		Account payable	210		3 600
		<i>The purchase of furniture on account.</i>			
	5	Supplies	124	300	
		Accounts payable	210		300
		<i>The purchase of supplies on account.</i>			
	6	Cash	101	800	
		Service revenue	401		800
		<i>The cash revenue of the month.</i>			
	7	Utilities expense	620	200	
		Cash	101		200
		<i>The payment of the utilities of the month.</i>			
	8	Accounts receivable	106	1 700	
		Service revenue	401		1 700
		<i>The credit revenue of the month.</i>			

2.4 Preparing a Trial Balance

❖ Trial Balance

The equality of debits and credits in the ledger is tested periodically by preparing a trial balance, which lists the balance in each account after the posting process has been completed. The trial balance is prepared using the following procedure:

1. Determine the balance of each account in the ledger.
2. List each account and place its balance beside it.
3. Compute the total of the debit balances.
4. Compute the total of the credit balances.
5. Verify that the sum of the debit balances equals the sum of the credit balances.

Each amount in the trial balance is simply the final balance of each account in the ledger.

EXAMPLE 2-4 Preparing a trial balance

Refer to Example 2-3 where the general ledger was based upon the balance column format. To prepare a trial balance for Emily Schneider's business on December 31, 20××, each account balance, beginning with the Cash account, is copied into a format below:

EMILY SCHNEIDER, PUBLIC ACCOUNTANT

Trial Balance

		December 31, 20××	
Acct. No.	Account Title	Debit	Credit
101	Cash	\$ 9 100	
106	Accounts receivable	1 700	
124	Supplies	300	
163	Equipment	3 000	
165	Furniture	3 600	
210	Accounts payable		\$ 3 900
301	Emily Schneider, capital		12 000
401	Service revenue		2 500
610	Rent expense	500	
620	Utilities expense	200	
	Totals	<u>\$ 18 400</u>	<u>\$ 18 400</u>

❖ Locating and Correcting Errors

A trial balance that does not balance may reveal the following types of errors:

1. Errors in preparing the trial balance, such as:
 - a. One of the columns of the trial balance was incorrectly added.
 - b. The amount of an account balance was incorrectly recorded on the trial balance.
 - c. A debit balance was recorded on the trial balance as a credit, or vice versa, or a balance was omitted entirely.
2. Errors in determining the account balances, such as:
 - a. A balance was incorrectly computed.
 - b. A balance was entered in the wrong balance column.
3. Errors in recording a transaction in the ledger, such as:
 - a. An erroneous amount was posted to the account.
 - b. A debit entry was posted as a credit, or vice versa.
 - c. A debit or a credit posting was omitted.

If the trial balance is **in balance** (that is, debits equal credits), there is some indication of recording accuracy. Errors, however, can still be made. The trial balance cannot detect errors such as double-posting of debits and credits, and posting amounts to the wrong accounts.

Errors must be corrected but never by erasing journal entries or postings because this alters the original record. If an error is discovered before posting or an incorrect amount is posted, corrections can be made by ruling a single line through the incorrect data and writing in the correct data. If a posting is made to an incorrect account, a correcting journal entry is required. The correcting journal entry also requires a complete explanation.

❖ Formatting Conventions

The following formatting conventions are usually adopted:

- ▶ Commas to indicate thousands of dollars and decimal points to separate dollars and cents are not necessary except on un-ruled paper.
- ▶ Dollar signs are not used in journals and ledgers but are required on financial reports — before the first amount in each column of figures and to indicate totals. See our examples of dollar signs on a financial report.

2.5 Using the Information—the Debt Ratio

Throughout the course we will be introduced to various accounting applications that help users of financial accounting. For example, companies usually finance assets using both debt and equity. The debt ratio is used to assess the risk of a company not being able to pay debts on time. It is calculated as follows:

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

The extent to which a company is financed by debt is known as the degree of **financial leverage**. It is sometimes called trading on the equity. A highly leveraged firm is considered risky because it is obligated to repay large amounts of loans as well as interest. A firm's debt ratio should be evaluated in the context of the nature of the firm's activities, its ability to generate cash to repay debt, current economic conditions, and the general level of debt held by other firms in the same industry.

Vocabulary

economic event	(经济业务)
source document	(原始凭证)
external transaction	(外部业务)
internal transaction	(内部业务)
account	(账户)
debit	(借方)
credit	(贷方)
rules of debits and credits	(借贷规则)
cash	(现金)
cash in bank	(银行存款)
receivable	(应收款项)
prepaid expense	(预付费用)
payable	(应付款项)
unearned revenue	(预收收入)

investment	(投资)
withdrawal	(提存)
temporary account	(暂时账户)
nominal account	(虚账户)
real account	(实账户)
chart of accounts	(科目表)
general ledger	(总分类账)
normal balance	(正常余额)
journalizing	(记日记账)
compound journal entry	(复合分录)
general journal	(普通日记账)
posting	(过账)
accounting cycle	(会计循环)
trial balance	(试算表)
adjustment	(账项调整)
adjusted trial balance	(调整后试算表)
closing	(结账)
post-closing trial balance	(结账后试算表)
debt ratio	(负债比率)
financial leverage	(财务杠杆)

Self-Test Questions

Answer of these questions appears at the end of lesson cases.

- Which of these is (are) an example of an asset account? _____.
 - Service Revenue
 - Withdrawals
 - Supplies
 - All of the above
- Which of these statements is false? _____.
 - Increases in assets and increases in revenues are recorded with a debit
 - Increases in liabilities and increases in owner's equity are recorded with a

credit

C. Increases in both assets and withdrawals are recorded with a debit

D. Decreases in liabilities and increases in expenses are recorded with a debit.

3. Which of these statements is not correct? ____.

A. The account is a basic summary device used in accounting

B. A business transaction is recorded first in the journal and then posted to the ledger

C. The ledger is a chronological listing of all transactions

D. The debit entry is recorded first in a journal entry, then the credit entry

4. Which of these accounts has a normal debit balance? ____.

A. Rent Expense

B. Withdrawals

C. Service Revenue

D. Both A and B have a normal debit balance

5. Which of the following statements is correct? ____.

A. The chart of accounts is a list of all accounts with their balances

B. The trial balance is a list of all accounts with their balances, divided as debit or credit

C. The ledger is maintained in chart-of-accounts order

D. Both B and C are correct

Discussion Questions

1. Why is the evidence provided by business papers important to accounting?

2. What is an account? What is a ledger?

3. What is the meaning of each of the following: (a) debit, (b) to debit, (c) credit, and (d) to credit?

4. If a transaction has the effect of decreasing an asset, is the decrease recorded as a debit or as a credit? If the transaction has the effect of decreasing a liability, is the decrease recorded as a debit or as a credit? Why are the rules of debit and credit the same for both liability and owner's equity accounts?

5. Why is a trial balance prepared? If a wrong amount was journalized and posted to the accounts, how should it be corrected?

Exercises

Exercise 2-1

Prepare the following columnar form. Then enter the word *debit* or *credit* in each of the last three columns to indicate the action necessary to increase the account, to indicate the action necessary to decrease the account, and to show the normal balance of the account.

Kind of Account	Increase	Decrease	Normal Balance
Asset			
Liability			
Owner's capital			
Owner's withdrawals			
Revenue			
Expense			

Exercise 2-2

Place the following T accounts on a sheet of notebook paper: Cash; Accounts Receivable; Office Supplies; Office Equipment; Accounts Payable; J. J. Wright, Capital; Services Revenue; and Utilities Expense. Then record these transactions by entering debits and credits directly in the accounts. Use the transaction letters to identify amounts entered in the accounts.

- a. J. J. Wright began a service business, called N. E. Time, by investing \$ 3 500 in the business.
- b. Purchased office supplies for cash, \$ 90.
- c. Purchased office equipment on credit, \$ 2 800.
- d. Received \$ 500 cash for services provided to a customer.
- e. Paid for the office equipment purchased in transaction c.
- f. Billed a customer \$ 400 for services provided to the customer.
- g. Paid the monthly utility bills, \$ 60.
- h. Collected \$ 200 of the amount owed by the customer of transaction f.

Exercise 2-3

After recording the transactions of Exercise 2-4, prepare a trial balance for N. E. Time. Use the current date.

Problems**Problem 2-1**

April Stewart opened an advertising business and during a short period as an agent completed these business transactions:

- a. Invested \$ 50 000 in cash and office equipment with a \$ 20 000 fair value in an advertising agency she called Stewart Advertising.
- b. Purchased land valued at \$ 60 000 and a small office building valued at \$ 230 000, paying \$ 43 500 cash and signing a long-term note payable to pay the balance over a period of years.
- c. Purchased office supplies on credit, \$ 480.
- d. Stewart contributed her personal automobile, which had a \$ 17 200 fair value, for exclusive use in the business.
- e. Purchased additional office equipment on credit, \$ 2 500.
- f. Paid the office secretary's salary, \$ 800.
- g. Sold an advertisement and collected a \$ 3 500 cash fee on the sale.
- h. Paid \$ 450 for a magazine advertisement that had already appeared.
- i. Paid for the supplies purchased on credit in transaction c.
- j. Purchased a new typewriter for the business, paying \$ 1 000 cash plus an old typewriter carried in the accounting records at \$ 200.
- k. Completed a marketing research assignment on credit and billed the client \$ 1 300.
- l. Paid the secretary's salary, \$ 800.
- m. Received payment in full for the marketing research of transaction k.
- n. Stewart withdrew \$ 1 800 from the business to pay personal expenses.

Required:

- a. Open the following T accounts: Cash; Accounts Receivable; Office Supplies; Automobiles; Office Equipment; Building; Land; Accounts Payable; Long-Term Notes Payable; April Stewart, Capital; April Stewart, Withdrawals; Advertising Fees Earned; Marketing Re-

search Fees Earned; Office Salaries Expense; and Advertising Expense.

b. Show the effects of the transactions on the accounts by entering debits and credits directly in the accounts. Use the transaction letters to identify each debit and credit amount.

c. Determine the balance of each account in the ledger and prepare a trial balance using the current date.

Problem 2–2

Mike Leaman completed these transactions during April of the current year:

- Apr. 1 Began an engineering firm by investing cash, \$ 25 000; drafting supplies, \$ 700; and office and drafting equipment, \$ 18 500.
 - 1 Prepaid two months' rent in advance on suitable office space, \$ 3 100.
 - 3 Paid the annual premium on an insurance policy taken out in the name of the business, \$ 2 400.
 - 4 Purchased drafting equipment, \$ 680, and drafting supplies, \$ 90, on credit.
 - 9 Delivered a set of plans to a contractor and collected \$ 4 000 cash in full payment.
 - 15 Paid the draftsman's salary, \$ 960.
 - 16 Completed and delivered a set of plans to the City of Camden on credit, \$ 7 800.
 - 18 Purchased drafting supplies on credit, \$ 40.
 - 19 Paid for the equipment and supplies purchased on Apr. 4.
 - 26 Received \$ 7 800 from the city of Camden for the plans delivered on Apr. 16.
 - 27 Mike Leaman withdrew \$ 2 000 from the business for personal use.
 - 28 Paid for the supplies purchased on Apr. 18.
 - 29 Completed engineering work for Acme Construction on credit, \$ 1 400.
 - 30 Paid the draftsman's salary, \$ 960.
 - 30 Paid the April utility bill, \$ 170.
 - 30 Paid the blueprinting expenses incurred in April, \$ 110.

Required:

- a. Open the following accounts: Cash; Accounts Receivable; Drafting Supplies; Prepaid

Insurance; Prepaid Rent; Office and Drafting Equipment; Accounts Payable; Mike Leaman, Capital; Mike Leaman, Withdrawals; Engineering Fees Earned; Salaries Expense; Blueprinting Expense; and Utilities Expense.

b. Prepare and post general journal entries to record the transactions. Prepare a trial balance, titling it Mike Leaman, Engineer.

Problem 2-3

Jay Ball completed these transactions during November of the current year:

- Nov. 1 Began a new chiropractic practice by investing \$ 27 000 in cash and medical equipment having a \$ 20 500 fair value.
- 1 Rented the furnished office of a chiropractor who was retiring because of illness, and paid the rent (expense) for November, \$ 1 600.
- 1 Took out a malpractice insurance policy giving one year's protection and paid the premium (expense) for the month of November, \$ 1 500.
- 3 Purchased medical supplies on credit, \$ 580.
- 9 Completed chiropractic work and immediately collected \$ 2 400 cash for the work.
- 13 Paid for the medical supplies purchased on November 3.
- 16 Completed chiropractic work for Ed Albe on credit, \$ 700.
- 23 Completed chiropractic work for Pat Gillespie on credit, \$ 200.
- 26 Received \$ 700 from Ed Albe for the work completed on Nov. 16.
- 28 Jay Ball wrote a \$ 70 check on the bank account of the chiropractic practice to pay his home telephone bill.
- 29 Purchased additional medical supplies on credit, \$ 340.
- 30 Paid the November telephone bill of the office, \$ 80.
- 30 Paid the salaries of the receptionist and assistant, \$ 2 350.
- 30 Prepaid the rent on the office for December and January, \$ 3 200.
- 30 Prepaid the malpractice insurance premium for the next three months, \$ 4 500.

Required:

a. Open the following accounts: Cash; Accounts Receivable; Medical Supplies; Prepaid Insurance; Prepaid Rent; Medical Equipment; Accounts Payable; Jay Ball, Capital; Jay Ball, Withdrawals; Chiropractic Fees Earned; Salaries Expense; Insurance Expense;

Rent Expense; and Telephone Expense.

b. Prepare general journal entries to record the transactions, post to the accounts, and prepare a trial balance titled Jay Ball, Chiropractor.

c. Prepare an income statement for the month ended November 30.

d. Prepare a statement of changes in owner's equity for the month ended November 30.

e. Prepare a balance sheet dated November 30.

Answers to Self-Test Questions:

1. c 2. a 3. c 4. d 5. d

上海财经大学出版社

3 Adjusting the Accounts, Preparing the Statements, and Completing the Accounting Cycle



Learning Objectives

After studying lesson 3, you should be able to:

1. *Understand the need for adjustments*
2. *Adjust the accounts*
3. *Prepare adjusted trial balance and financial statements*
4. *Use the worksheet*
5. *Close entries*
6. *Prepare post-closing trial balance*
7. *Understand the accounting cycle*
8. *Use the information—the current ratio and the profit margin*

Lesson 3 introduces the adjusting process. Cash and accrual accounting are illustrated and differentiated. The accounting period concept, the revenue and matching principles, and the time-period concept are explained. Deferral, and accruals are defined. The five categories of adjusting entries—prepaid expenses, depreciation, accrued expenses, accrued revenues, and unearned revenues—are illustrated and described in details.

The last part of the lesson focuses on the financial statements. We learn how to prepare an adjusted trial balance and use it to prepare the financial statements. The relationship among the financial statements is emphasized.

3.1 The Need for Adjustments

Businesses need to have information on a regular basis. Most of them divide their life into smaller segments, usually a year. The life of a business is divided into different periods, called **accounting periods**, for the purpose of preparing periodic financial statements. As a result, the *time period principle* has important implications in the practice of accounting.

❖ Time Period Principle

According to the **time period principle** (sometimes called the **periodicity assumption**), the life of a business is divisible into time periods of equal length. Financial reports are prepared at the end of each fiscal period (one year); interim financial reports are prepared monthly or quarterly. Income is measured accurately each period.

Annual accounting periods are the norm. A **fiscal year** is any consecutive 12-month period. This need not coincide with the **calendar year** ending on December 31. Firms often choose a fiscal year corresponding with their **natural business year**, whose end is a low point in business activity.

❖ Need for Adjustments at the End of an Accounting Period

Adjustments are necessary to record internal economic events such as the expiration of costs. These internal transactions are typically not evidenced by any source documents, as are external transactions. Note that adjustments are not corrections of errors.

Before financial statements are prepared at the end of an accounting period, it is necessary to adjust the account balances that are not up-to-date. The purpose of making adjustments is to ensure that the information on accounting statements is comparable from period to period.

Adjustments are required to match:

- ▶ associated revenues with their related costs
- ▶ revenues and expenses to their appropriate time periods

The adjustment process is based on the following two accounting principles:

- ▶ The *revenue principle* states that revenues are recorded when earned, and the a-

mount of revenue recorded equals the cash value of the goods or services transferred to the customer.

► The *matching principle* states that expenses should be deducted from (matched against) the revenues earned in the same period.

❖ Accrual and Cash Basis of Accounting

In accrual-basis accounting, the accountant enters the transactions when the business performs a service or incurs an expense.

In some cases, accountants use cash-basis accounting. In cash-basis accounting, cash receipts are treated as revenues, and cash payments are treated as expenses.

The **accrual basis** of accounting matches revenues *earned* with expenses *incurred*, whereas the **cash basis** matches revenues *received* with expenses *paid*. The cash basis is not satisfactory for most businesses because it results in financial statements that are not comparable from period to period, except when the amounts of **prepaid, unearned, and accrued items** are not material. Only accrual accounting, with its emphasis on matching, and hence the need for adjustments, is acceptable under GAAP.

Examples 3-1 illustrates the accrual and cash basis of accounting.

EXAMPLE 3-1 Accrual basis and cash basis accounting

In its first year of operations, Harris Co. earned \$ 39 000 in revenues and received \$ 33 000 cash from customers. The company incurred expenses of \$ 22 500, but had not paid for \$ 2 250 of them at year end. In addition, Harris prepaid \$ 3 750 for expenses that would be incurred the next year. Calculate the first year's net income under a cash basis and under an accrual basis.

Under the cash basis of accounting, only cash received represents revenue while cash paid represents expenses.

Cash basis:

Revenues (cash receipts)	\$ 33 000
Expenses (cash payments) (22 500-2 250+3 750)	<u>24 000</u>
Net income	<u>\$ 9 000</u>

Under the accrual basis of accounting, revenues and expenses are recorded when they happen, regardless of whether cash has been received or paid.

Accrual basis:

Revenues (earned)	\$ 39 000
Expenses (incurred)	<u>22 500</u>
Net income	<u>\$ 16 500</u>

3.2 Adjusting the Accounts

Adjusting entries can be divided into **deferrals and accruals**. Each adjustment affects *both* the balance sheet and income statement. The adjustments can be further divided into five categories: **prepaid expenses, depreciation, unearned revenues, accrued expenses, and accrued revenues**.

❖ Prepaid Expenses

A **prepaid expense** is an economic benefit that has been paid for in advance of its use. It requires adjustment because the cash is paid in one period, but the resource is not completely used until a later period. The prefix *prepaid* refers to an asset account. *Prepaid rent* is an asset account, while *rent expense* is an expense account. As the asset is consumed (expired), the future benefit decreases and the portion of the asset used becomes an expense. The remaining future benefit represents the asset. Examples of prepaid expenses include prepaid rent, prepaid insurance, office supplies, store supplies, and factory supplies.

Asset method. If prepayments are initially recorded as assets, they will be incorrectly stated during the accounting period as they are consumed. This must be adjusted at the end of the accounting period to reflect the amount used. Part of the asset or the entire asset has become an expense. The adjusting entry requires a debit to an expense account and a credit to an asset account, as follows:

Expense	xxx
Asset	xxx

Expense method. Prepayments initially recorded as expenses will be improperly stated during the accounting period and must be adjusted at the end of the accounting period to reflect the amount of future benefit remaining and to avoid overstating expenses.

❖ Depreciation

Depreciation is the term used for the expiration or using up of a capital (also known as long-lived, fixed or plant) asset (for example, equipment and buildings). It is the allocation of the cost of a plant asset to expense over its useful life.

The following points define depreciation:

► Depreciation is similar to the expiration or using up of a prepayment, except the amount of depreciation in each accounting period is based on *subjective estimates*, in other words, judgment in terms of estimating the asset's useful life and estimating its salvage or trade-in value.

► Depreciation is an estimate of the decline in *usefulness*, not necessarily a decline in *value*.

► Depreciation is a method of *cost allocation*, not *asset valuation*. A capital asset whose market value is increasing would still be amortized (except for those capital assets, such as land, that are not amortized). While the asset generates revenues, it gradually wears out. To match the expense of the asset to the revenues it is generating, the cost of the asset must be spread over its useful life as an expense.

The amount of the asset used in a period is determined by allocating the net amortizable cost of the asset (original cost less expected trade-in allowance) over the expected useful life of the asset. The general format of the entry to record depreciation expense of an asset is shown as follows:

Expense (Depreciation expense)	xxx
Asset (Accumulated depreciation)	xxx

This entry is similar to the entry used to record expiration of a prepayment. *Depreciation expense* is an income statement item. The latter is a contra asset account on the balance sheet. A **contra account** is an account that is subtracted from an associated account to show a more proper amount for the item recorded. The contra asset account, accumulated depreciation, is used to reflect the total decline in usefulness of the asset. The balance in a contra account is subtracted from the balance of its associated account when preparing financial statements. **Net book value** is the difference between the original cost of the asset and the contra asset account. The purpose of accumulating depreciation in a contra asset account is to keep track of the original cost of an asset separately from the amount of depreciation that has been charged to expense (in accordance with the cost principle).

Example 3-3 illustrates the general entries for depreciation.

EXAMPLE 3-2 Recording depreciation

Soft-rock Minerals purchased a vehicle on March 1, 20×1, for cash of \$ 34 000. It will be used by the president for four years and then sold for about \$ 10 000. Soft-rock's year end is December 31.

The calculation of depreciation and the resulting adjusting journal entry are illustrated as follows:

20×1

Dec. 31	Depreciation expense, vehicle	5 000
	Accumulated depreciation, vehicle	5 000

To record 10 months of depreciation on the vehicle;

$34\ 000 - 10\ 000 = 24\ 000$; $24\ 000 \div 4\ \text{yrs} = 6\ 000/\text{yr}$;

$6\ 000 \times 10 \div 12 = 5\ 000$.

20×2

Dec. 31	Depreciation expense, vehicle	6 000
	Accumulated depreciation, vehicle	6 000

To record annual depreciation on the vehicle.

To take this question one step further, the entry for Vehicle will be shown on each of the balance sheets for December 31, 20×1 and December 31, 20×2, as follows:

December 31, 20×1

Vehicle	\$ 34 000
Less: Accumulated depreciation	<u>5 000</u>
	<u>\$ 29 000</u>

December 31, 20×2

Vehicle	\$ 34 000
Less: Accumulated depreciation	<u>11 000</u>
	<u>\$ 23 000</u>

❖ Unearned Revenues

Unearned revenue (also called **advance from clients** or **deferred revenue**) represents payment received for goods or services in advance of their delivery. Cash will be

debited to record the amount received, and unearned revenue will be credited to record the amount received but not yet earned.

Unearned revenue arises when a business receives cash in one period but does not earn all of it until a later period. Thus, unearned revenue is a liability because the business owes the customer a good or service. The receipt of the cash would increase cash and increase a liability. When the revenue is earned, the adjustment would usually decrease the liability and increase a revenue.

Example 3-3 shows the entries to record unearned revenue.

EXAMPLE 3-3 Recording unearned revenue

On November 1, 20×1, Fastfoot Industries collected \$ 12 000 from a customer for services to be provided in the future. On December 31, 20×1, Fastfoot's year end, it was determined that \$ 3 000 of this amount remained unearned.

The entries for November 1 and December 31 are:

Nov. 1	Cash	12 000
	Unearned revenue	12 000
	<i>To record unearned revenue.</i>	
Dec. 31	Unearned revenue	9 000
	Revenue	9 000

To record earned portion of unearned revenue;

$\$ 12\ 000 - \$ 3\ 000 = \$ 9\ 000.$

The principle of revenue recognition has been applied to record the entry on December 31. Revenue is recognized as it is earned, and by this date, \$ 9 000 has been earned.

As illustrated in the previous example, if receipts of payments have been initially recorded as liabilities (unearned revenue), an adjustment must be made at the end of the accounting period to reflect amounts earned and to show the reduction of the liability. Alternatively, the receipt of payment can be initially recorded as revenue. If the revenue is earned by the end of the accounting period, no adjusting entry is required.

❖ Accrued Expenses

An **accrued expense** is recorded by preparing an adjusting entry. An adjusting entry is required because an expense has been incurred during the accounting period but it has not been recorded through the normal course of accounting entries. An accrued liability may exist

for interest, wages, taxes, or other expenses that have been incurred in the accounting period but have not been paid by period end. Those who have provided services to the business entity during the period have a claim against the business for any amounts owed them. According to the *matching principle*, these accrued expenses must be recorded in the period that the effort was expended.

Payables for accrued expenses differ from regular trade payables. Trade accounts payable are usually documented by invoices already received from suppliers, but accrued expenses are continuous transactions that are determined by careful account analysis.

EXAMPLE 3-4 Adjustment and payment of accrued expenses

On October 31, 20××, Offsite Data Services recorded three days of unpaid salaries of \$ 30 000. The total salaries of \$ 50 000 for the five-day workweek will be paid on November 2, 20××. The adjustment and subsequent payment of salaries are illustrated as follows:

20××		
Oct. 31	Salaries expense	30 000
	Salaries payable	30 000
	<i>To record accrued salaries.</i>	
Nov. 2	Salaries payable	30 000
	Salaries expense	20 000
	Cash	50 000
	<i>To record payment of salaries.</i>	

❖ Accrued Revenues

Accrued revenue is recorded by preparing an adjusting entry. An adjusting entry is required because revenue has been earned during the accounting period but it has not been recorded through the normal course of accounting entries. The company may record revenue during the period only when payment is received; or the service period may straddle two accounting periods. The *revenue recognition principle*, however, requires that revenue be recorded during the period that it is earned, regardless of when the actual cash is collected.

EXAMPLE 3-5 Accrued revenues

Soft recorded unbilled and uncollected revenues of \$ 17 000 on March 31, 20×1. On April 16, \$ 12 000 of these were collected.

The adjusting entry for accrued revenues, along with their subsequent collection, is illustrated as follows:

20×1

Mar. 31	Accounts receivable	17 000
	Revenues	17 000

To record accrued revenues.

Apr. 16	Cash	12 000
	Accounts receivable	12 000

To record collection of receivable.

3.3 Adjusted Trial Balance and Preparation of Financial Statements

The **adjusted trial balance** is prepared after the adjusting entries have been journalized and posted. It is the one that reflects revised account balances due to the end-of-period adjustments. The adjusted trial balance serves as the basis for the preparation of the financial statements.

The financial statements are prepared using the account balances found on the adjusted trial balance. The income statement is prepared first, followed by the statement of owner's equity, and then the balance sheet.

The essential features of all financial statements are:

1. The heading of the statement that includes:
 - a. the name of the entity,
 - b. the title of the statement, and
 - c. the date or period covered by the statement.
2. On the income statement, expenses are listed in descending order by amount, except for Miscellaneous Expense, which is usually listed last.

The following relationships exist among the financial statements:

- a. Net income calculated from the income statement is used in preparing the statement of owner's equity.
- b. The ending balance of Capital is used in preparing the balance sheet.

Accrual accounting provides some ethical challenges that cash accounting avoids. Since

expenses are not necessarily expensed when paid in accrual accounting, management can exercise some discretion when recording expenses. Estimates must be used when recording depreciation, accrued revenues, and accrued expenses. Unethical people can manipulate these estimates to reflect favourably upon their company.

Let's go on with examples of Emily Schneider (Example 2-2, 2-3 and 2-4) in Lesson 2 to demonstrate how to prepare the adjusted trial balance. The Unadjusted trial balance numbers reflect the balances in the ledger accounts *before* the adjusting journal entries at the end of the accounting period. The Adjustments show the adjustments that must be made to various accounts to bring them to their proper balances. The adjusted trial balance is the result of the unadjusted trial balance and the adjustments.

EXAMPLE 3-6 Preparation of remaining transactions and adjustments

1. Journalize the remaining entries.

Dec. 21 She collected cash from a client in advance at \$ 900.

Dec. 26 She paid \$ 300 to her creditors.

Dec. 28 She collected \$ 600 from her client for her services rendered before.

Dec. 30 She withdrew \$ 1 600 for her personal use.

Journal			Page 2		
Date		Account titles and explanation	Post. Ref.	Debit	Credit
Remaining entries					
Dec.	21	Cash		900	
		Unearned service revenue			900
		<i>Receipt of cash in advance.</i>			
	26	Accounts payable		300	
		Cash			300
		<i>Payment for creditors.</i>			
	28	Cash		600	
		Accounts receivable			600
		<i>Receipt from client.</i>			
	30	Emily Schneider, withdrawal		1 600	
		Cash			1 600
		<i>Withdrawals of the owner.</i>			

2. Journalize the adjusting entries.

- a. Accrued service revenue at \$ 400.
- b. 1/3 of unearned revenue became earned revenue.
- c. Supplies on hand at \$ 100.
- d. Depreciation for equipment at \$ 50.
Depreciation for furniture at \$ 60.
- e. Accrued salary at \$ 500.

Journal			Page 3	
Date		Account titles and explanation	Post. Ref.	Debit Credit
Adjustments				
Dec.	31	Accounts receivable		400
		Service revenue		400
	31	Unearned service revenue		300
		Service revenue (900×10/30)		300
	31	Supplies expense (300-100)		200
		Supplies		200
	31	Depreciation expense-equipment		50
		Depreciation expense-furniture		60
		Accumulated depreciation-equipment		50
		Accumulated depreciation-furniture		60
	31	Salary expense		500
		Salary payable		500

3. After posting, all ledger accounts are below (for illustration, T accounts are used. Shaded area refers to the transactions in Lesson 2) :

Cash	
12 000	500
800	3 000
900	200
600	300
	1 600
Bal.	8 700

Accounts Receivable	
1 700	600
1 100	
Adj.	400
Bal.	1 500

Supplies

300	Adj.	200
Bal.	100	

Equipment

3 000	
-------	--

Accumulated depreciation-equipment

	Adj.	50
--	------	----

Furniture

3 600	
-------	--

Accumulated depreciation-furniture

	Adj.	60
--	------	----

Accounts payable

300	3 600
	300
Bal.	3 600

Salary payable

	Adj.	500
--	------	-----

Unearned service revenue

Adj.	300	900
Bal.		600

Emily Schneider, capital

	12 000
--	--------

Emily Schneider, withdrawals

1 600	
-------	--

Service revenue

	800
	1 700
	2 500
Adj.	400
Adj.	300
Bal.	3 200

Rent expense

500	
-----	--

Utilities expense

200	
-----	--

Salary expense

Adj.	500	
------	-----	--

Depreciation expense—equipment

Adj.	50	
------	----	--

Depreciation expense—furniture

Adj.	60	
------	----	--

Supplies expense

Adj.	200	
------	-----	--

4. Based on these adjusted accounts, the adjusted trial balance is prepared:

Cash	\$ 8 700	
Accounts Receivable	1 500	
Supplies	100	
Equipment	3 000	
Accumulated depreciation—equipment		\$ 50
Furniture	3 600	
Accumulated depreciation—furniture		60
Accounts payable		3 600
Salary payable		500
Unearned service revenue		600
Emily Schneider, capital		12 000
Emily Schneider, withdrawals	1 600	
Service revenue		3 200
Rent expense	500	
Utilities expense	200	
Salary expense	500	
Depreciation expense—equipment	50	
Depreciation expense—furniture	60	
Supplies expense	200	
Total	<u>\$ 20 010</u>	<u>\$ 20 010</u>

5. Based on the adjusted trial balance, financial statements can be prepared:

Emily Schneider, Accountant		
Income statement		
For the month ended December 31, 20××		
Revenue		
Service revenue		\$ 3 200
Expenses		
Rent expense	\$ 500	
Salary expense	500	
Utilities expense	200	
Supplies expense	200	
Depreciation expense—furniture	60	
Depreciation expense—equipment	50	
Total expenses		<u>1 510</u>
Net income		<u>\$ 1 690</u>

Emily Schneider, Accountant	
Capital Statement	
For the month ended December 31, 20××	
Emily Schneider, capital December 1, 20××	\$ 0
Investment during the month	12 000
Add : net income	1 690
Less: withdrawals	<u>(1 600)</u>
Emily Schneider, capital December 31, 20××	<u>\$ 12 090</u>

Emily Schneider, Accountant			
Balance Sheet			
December 31, 20××			
Assets		Liabilities	
Cash	\$ 8 700	Accounts payable	\$ 3 600
Accounts Receivable	1 500	Salary payable	500
Supplies	100	Unearned service revenue	600
Equipment	3 000	Total liabilities	4 700
Less: Accumulated de-precia- tion-equipment	<u>50</u>		
	2 950		
Furniture	3 600	Capital	
Less: Accumulated deprecia- tion-furniture	<u>60</u>	Emily Schneider, capital	<u>\$ 12 090</u>
	3 540		
Total assets	<u>\$ 16 790</u>	Total liabilities and capital	<u>\$ 16 790</u>

3.4 Using the Worksheet

A **worksheet** is a working paper used by an accountant to organize accounting information for preparing the financial statements and adjusting entries. Preparing worksheets is an optional procedure in the accounting cycle and summarizes steps 4, 5 and 6 as shown in Exhibit 2–3. Financial statements are used externally and must follow certain formats. Worksheets, however, are informal documents for the accountant's use only, and enable the accountant to see the entire accounting process from beginning to end.

❖ Purpose of the Worksheet

The worksheet is used to gather information on adjustments and account balances for the financial statements. This helps reduce the chance of error, omission and duplication, and assures mathematical accuracy prior to the actual preparation of the formal financial statements. The worksheet is useful in preparing interim financial statements. The adjustments are reflected on the worksheet only, and are not yet recorded in the journal or ledger accounts. Interim statements can provide useful monthly or quarterly data without disrupting the routine record-keeping. The worksheet facilitates the recording of adjusting and closing entries.

❖ Preparing Worksheets

We should avoid taking shortcuts when preparing worksheets. It is recommended that we take the following steps to ensure mathematical accuracy. Complex situations will be easier to work with if we follow a structured plan.

Example 3-7 demonstrates a worksheet with five sets of double columns;

1. Unadjusted trial balance—the accounts and their balances are taken from the ledger and entered here.
2. Adjustments—adjusting entries are recorded here. Note that the worksheet is not a journal, but a working paper. It is used to gather the adjustment data. The adjusted trial balance is prepared by combining the adjustments with the unadjusted balances.
3. Adjusted trial balance—the results of combining the unadjusted trial balance and adjustments columns are entered here.
4. Income statement—those accounts that belong to the income statement are extended from the adjusted trial balance columns to the income statement columns.
5. Balance sheet—those accounts that belong to these financial statements are extended from the adjusted trial balance into the last two columns of the worksheet.

The worksheet does not eliminate the need to journalize and post the adjusting journal entries; this must still be done in order for the information to enter the accounting system. Journalizing and posting the adjusting journal entries will bring the ledger into agreement with the adjusted trial balance amounts shown on the worksheet.

EXAMPLE 3-7**Emily Schneider, Accountant Worksheet for the Month of December 20xx**

Titles	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
Cash	8 700				8 700				8 700	
Accounts receivable	1 100		a. 400		1 500				1 500	
Supplies	300			c. 200	100				100	
Equipment	3 000				3 000				3 000	
Accumulated depreciation-equipment				(d1) 50		50				50
Furniture	3 600				3 600				3 600	
Accumulated depreciation-furniture				(d2) 60		60				60
Accounts payable		3 600				3 600				3 600
Salary payable				e. 500		500				500
Unearned service revenue		900	b. 300			600				600
Emily Schneider, capital		12 000			12 000					12 000
Emily Schneider, withdrawals	1 600				1 600				1 600	
Service revenue		2 500		a. 400		3 200		3 200		
				b. 300						
Rent expense	500				500		500			
Utilities expense	200				200		200			
Salary expense			e. 500		500		500			
Depreciation expense-equipment			(d1) 50		50		50			
Depreciation expense-furniture			(d2) 60		60		60			
Supplies expense			c. 200		200		200			
Total	<u>19 000</u>	<u>19 000</u>	<u>1 510</u>	<u>1 510</u>	<u>20 010</u>	<u>20 010</u>	1 510	3 200	18 500	16 810
Net income							1 690			1 690
							<u>3 200</u>	<u>3 200</u>	<u>18 500</u>	<u>18 500</u>

3.5 Closing Entries

Accounts are either *real* (permanent) or *nominal* (temporary). The balance sheet accounts such as cash accounts are real accounts, while the income statement consists of nominal accounts. **Real accounts** are *continuous* accounts—their balances are carried forward from one accounting period to the next. **Nominal accounts** are *periodic* accounts, and at the end of each accounting period, their balances are *closed* (transferred) to owner's equity.

Closing the accounts is the process that prepares the accounts for the next period. **Closing entries** transfer the balances in the temporary (or nominal) accounts (revenue, expense, and withdrawals accounts) to a balance sheet equity account (owner's capital for a sole proprietorship).

❖ Purpose of Closing Entries

The revenue, expense, and withdrawals (*dividends* for a corporation) accounts are nominal (temporary) accounts that are part of owner's equity. They are created as separate accounts to determine the net income for an accounting period and to keep a record of distributions to owners or shareholders.

At the end of an accounting period, an income statement is prepared. The revenue and expense accounts have served their purpose in determining the period's net income. New revenue and expense accounts will be needed for the next accounting period. The withdrawals account would also have served its purpose in determining the total withdrawals during the period.

The revenues and expenses are transferred to owner's capital through a closing account called **Profit loss summary/income summary**. The income summary account gathers the revenues and expenses during the closing process. The balance in the income summary after closing the revenues and expenses must equal the net income (loss); it is used to confirm that revenues and expenses have been closed properly. Once the net income (loss) has been proved, the balance in the income summary is transferred to the owner's capital account. Owner's withdrawals are transferred to owner's capital directly.

❖ **Preparing the Closing Entries**

The four closing entries are:

1. close revenues (credit balances) to income summary;
2. close expenses (debit balances) to income summary;
3. close income summary (the balance is net income or loss) to the owner's capital (or to retained earnings for corporations); and
4. close withdrawals (debit balance) to capital (or dividends to retained earnings for corporations).

The effect of closing entries on owner's equity can be simplified as follows:

Owner's Equity	
Decreases	Increases
• Withdrawals by owner	• Revenues
• Expenses	

EXAMPLE 3-8

Journal			Page 4		
Date		Account titles and explanation	Post. Ref.	Debit	Credit
Dec.	31	Service revenue		\$ 3 200	
		Income summary			\$ 3 200
		<i>Close revenue.</i>			
	31	Income summary		1 510	
		Rent expense			500
		Salary expense			500
		Utilities expense			200
		Supplies expense			200
		Depreciation expense—furniture			60
		Depreciation expense—equipment			50
		<i>Close expenses.</i>			

(Continued)

Journal			Page 4	
Date	Account titles and explanation	Post. Ref.	Debit	Credit
31	Income summary		1 690	
	Emily Schneider, capital			1 690
	<i>Close income summary.</i>			
31	Emily Schneider, capital		1 600	
	Emily Schneider, withdrawals			1 600
	<i>Close withdrawals.</i>			

3.6 Post-closing Trial Balance

A final step is needed to ensure that the journalizing and posting of closing entries have been done properly. After the closing entries are journalized and posted, the temporary (nominal) accounts should have a zero balance. The permanent (real) accounts are still open.

The post-closing trial balance is prepared to ensure that total debits still equal total credits in the remaining permanent accounts. The income statement accounts and withdrawals account should have zero balances because they have been closed. Only balance sheet accounts will appear in the post-closing trial balance.

EXAMPLE 3-9

Emily Schneider, Accountant

Trial Balance

December 31, 20××

Account	Debit	Credit
Cash	\$ 8 700	
Accounts receivable	1 500	
Supplies	100	

(Continued)

Account	Debit	Credit
Equipment	3 000	
Accumulated depreciation—equipment		\$ 50
Furniture	<u>3 600</u>	
Accumulated depreciation—furniture		60
Accounts payable		3 600
Salary payable		500
Unearned service revenue		600
Emily Schneider, capital		12 090
Total	<u>16 900</u>	<u>16 900</u>

3.7 Classification of Balance Sheet Items

A **classified balance sheet** is the one that shows assets and liabilities grouped in meaningful subclasses. Assets are grouped into three main categories — current assets, long-term investments, and fixed assets. Liabilities are grouped into two categories — current and long-term. Owner's equity represents the last subclass, and its format depends on whether the company is a single proprietorship, a partnership, or a corporation.

❖ Assets

► **Current assets** are cash and other assets that may reasonably be expected to be realized in cash or be sold or consumed within one year or one operating cycle of the business, whichever is longer. The **operating cycle** is the average time period between acquisition of merchandise or raw materials and the realization of cash from the sale of merchandise or manufactured products. Current assets include cash, temporary investments, accounts receivable, inventory, and prepaid expenses. The most liquid asset (cash) is shown first. Current assets are available to pay current liabilities. Current assets *less* current liabilities are known as **working capital**.

► **Long-term investments** are non-current assets, and include shares, bonds, long-term notes receivable, and land held for future expansion.

► **Fixed assets** are divided into tangible and intangible. **Tangible fixed assets**

are those used in the production or sale of other assets or services, are material in amount, and benefit more than one accounting period. Some firms use alternative terminology such as “Property, plant, and equipment,” “Land, buildings, and equipment,” or “Plant assets” as balance sheet classifications for fixed assets. An important feature of all tangible assets other than land is that they are subject to depreciation. In order to be classified as a fixed asset, the asset has to be in use, and depreciation reflects this usage. **Intangible fixed assets** are long-term fixed assets that have no physical existence but have value because of the rights conferred as a result of their ownership and possession. Examples include goodwill, patents, trademarks, copyrights, and franchises. Like tangible assets, intangible assets are material in amount and benefit more than one accounting period.

❖ Liabilities

An explanation of the two main categories of liabilities follows:

► **Current liabilities** are debts or other obligations that must be paid or liquidated within one year or within one operating cycle from the balance sheet date. The payment or liquidation of these liabilities usually requires using current assets or incurring new current liabilities. Examples include accounts payable, notes payable, wages payable, taxes payable, interest payable, and unearned revenues. Note that there is an important distinction between *payable* and *unearned*. *Rent payable* would require a payment of cash. *Unearned rent* would require the provision of a good or service.

► **Long-term liabilities** are not due and payable for a comparatively long period, usually beyond one year of the balance sheet date. Examples include mortgages payable, bonds payable, and long-term notes payable.

❖ Equity

The owner's equity section of a balance sheet differs for different forms of business ownership. For example:

In a single proprietorship, the equity section of the balance sheet is a single line. The beginning and ending balances of owner's equity are also shown on the statement of owner's equity.

In a partnership, the equity section of the balance sheet has a line for each partner's equity (capital). Changes in the partners' equity are also shown on the statement of partners' equities. Note that the names of the owner or partners are shown on the balance

sheet. This information is useful, given that the owners are responsible for business debts.

For the corporate form of ownership, the owner's equity section is referred to as **shareholders' equity**. Shareholders' equity is more complex than owner's equity. It consists of two main categories:

► **Contributed capital**, which represents amounts paid in by shareholders. This portion of shareholders' equity is called **common shares** if the corporation issues only one kind of share.

► **Retained earnings**, which represents the corporation's cumulative net incomes *less* net losses and dividends (distributions to shareholders) since inception.

EXAMPLE 3-10 Preparation of a classified balance sheet

ALPINE CLIMBING ADVENTURES

Balance Sheet

March 31, 20×2

Assets

Current assets:

Cash	\$ 15 000	
Accounts receivable	6 000	
Supplies	<u>540</u>	
Total current assets		\$ 21 540

Fixed assets:

Equipment	41 000	
Less: Accumulated depreciation	<u>14 000</u>	
Total capital assets		<u>27 000</u>

Total assets		<u><u>\$ 48 540</u></u>
--------------	--	-------------------------

Liabilities

Current liabilities:

Accounts payable	\$ 2 400	
Unearned revenues	22 000	
Current portion of long-term notes payable	<u>6 000</u>	
Total current liabilities		30 400

Long-term liabilities:

Long-term notes payable (less current portion)	5 000
Total liabilities	\$ 35 400
Owner's Equity	
Amy Rooniak, capital	13 140
Total liabilities and owner's equity	<u>\$ 48 540</u>

3.8 Using the Information—the Current Ratio

Previously in this lesson, we were introduced to the preparation of a classified balance sheet. One advantage of classification is that important relationships within the balance sheet can be easily obtained and analyzed.

One such relationship is the **current ratio** as a measure of a company's short-term debt-paying ability. This type of information is particularly useful to suppliers and bankers that do business with a firm, for example.

The current ratio is determined as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

A current ratio of 1.8 indicates that a company has \$ 1.80 of current assets for each dollar of current debt.

The current ratio should be interpreted in terms of the **liquidity** of a firm's current assets. The major components of current assets are receivables and inventories. Current assets that are liquid are readily convertible into cash. There may be a tendency for unethical or over-optimistic managers to overstate current assets and understate current liabilities.

Vocabulary

time period	(会计期间)
fiscal year	(财政年度)
calendar year	(日历年度)
natural business year	(自然经营年度)
adjustments	(账项调整)

accrual basis	(应计制、权责发生制)
cash basis	(现金制、收付实现制)
prepaid items	(预付项目)
unearned items	(预收项目)
accrued items	(应计项目)
deferrals and accruals	(递延与应计)
depreciation	(折旧)
contra account	(备抵账户)
net book value	(账面净值)
worksheet	(工作底稿)
closing entries	(结账分录)
income summary/Profit Loss summary	(收益汇总)
unearned revenue	(预收收入)
Advance from customers	(预收账款)
Prepaid expense	(待摊费用)
Accrued expense	(预提费用)
classified balance sheet	(分类资产负债表)
working capital	(营运资本)
long-term investment	(长期投资)
tangible fixed asset	(固定资产)
intangible fixed asset	(无形资产)
shareholders' equity	(股东权益)
contributed capital	(缴入资本)
common shares	(普通股股本)
retained earnings	(留存收益)
current ratio	(流动比率)
liquidity	(流动性)

Self-Test Questions

Answer of these questions appears at the end of lesson cases.

1. When should revenue be recorded under the accrual-basis and cash-basis of accounting? _____.

Accrual-Basis

a. When received

Cash-Basis

When the service is performed

- b. When the service is performed When the customer is billed
- c. When the customer is billed When received
- d. When the service is performed When received
2. Recording an expense when it is paid instead of when incurred is a violation of _____.
 a. The matching principle
 b. The time period concept
 c. The reliability concept
 d. The revenue principle
3. Failure to record an adjusting entry for an accrued expense, will result in the following _____.

	<u>Liabilities</u>	<u>Net Income</u>
a.	no effect	understate
b.	understate	overstate
c.	overstate	understate
d.	understate	no effect
4. An adjusting entry could contain all of the following except _____.
 a. a debit to Unearned Revenue
 b. a credit to Cash
 c. a debit to Interest Receivable
 d. a credit to Salary Payable
5. The 20×3 income statement showed Rent Expense of \$ 6 100. The related balance sheet account, Prepaid Rent, had a beginning balance of \$ 1 400 and an ending balance of \$ 1 200. The amount of cash paid for rent during 20×3 is _____.
 a. \$ 6 100
 b. \$ 1 200
 c. \$ 6 300
 d. \$ 5 900

Discussion Questions

1. Distinguish accrual-basis accounting from cash basis.
2. What is the purpose of making adjusting entries?

3. Name five categories of adjusting entries, and give an example of each.
4. What purposes does the adjusted trial balance serve?
5. Why is an unearned revenue a liability? Give an example.

Exercises

Exercise 3-1

Prepare adjusting journal entries on December 31, 20×3, prior to the preparation of annual financial statements, for the following independent situations:

- a. The Supplies account had a \$ 470 debit balance on January 1, 20×3; \$ 330 of supplies were purchased during the year; and a year-end inventory showed \$ 100 of supplies on hand.
- b. The Prepaid Insurance account had a \$ 1 700 debit balance at the end of the accounting period before adjustment for expired insurance. An examination of insurance policies showed \$ 1 360 of insurance had expired.
- c. The Prepaid Insurance account had a \$ 640 debit balance at the end of the accounting period before adjustment for expired insurance. An examination of insurance policies showed \$ 440 of unexpired insurance.
- d. Depreciation on equipment was estimated at \$ 3 470 for the accounting period.
- e. Six months' property taxes, estimated at \$ 1 260, have accrued but are unrecorded and unpaid at the accounting period end.

Exercise 3-2

Assume that the required adjustments of Exercise 3-2 were not made at the end of the accounting period. For each adjustment, tell the effect of its omission on the income statement and balance sheet prepared at that time.

Exercise 3-3

Determine the amounts indicated by the question marks in the following columns. The amounts in each column constitute a separate problem.

	(a)	(b)	(c)	(d)
Supplies on hand on January 1	\$ 180	\$ 410	\$ 745	\$?
Supplies purchased during the year	230	390	?	645
Supplies remaining at the year-end	80	?	115	560
Supplies expense for the year	?	320	850	425

Problems

Problem 3-1

Community Technical School's unadjusted trial balance on December 31, 20×3, the end of its annual accounting period, is as follows:

COMMUNITY TECHNICAL SCHOOL

Trial Balance

December 31, 20×3

Cash	\$ 7 200	
Office supplies	4 300	
Prepaid insurance	8 100	
Professional library	19 800	
Accumulated depreciation, professional library		\$ 8 490
Equipment	43 300	
Accumulated depreciation, equipment		14 900
Accounts payable		860
Unearned extension fees		2 400
Kay Perry, capital		55 950
Kay Perry, withdrawals	15 000	
Enrollment fees earned		43 400
Salaries expense	16 800	
Rent expense	9 600	
Advertising expense	500	
Utilities expense	1 400	
Totals	<u>\$ 126 000</u>	<u>\$ 126 000</u>

Required:

1. Set up accounts for the items in the trial balance plus these additional accounts: Accounts Receivable; Salaries Payable; Extension Fees Earned; Depreciation Expense, E-

quipment; Depreciation Expense, Professional Library; Insurance Expense; and Office Supplies Expense. Enter the trial balance amounts in the accounts.

2. Use the following information to prepare and post adjusting entries:

- a. An examination of insurance policies shows \$ 900 of expired insurance.
 - b. An inventory shows \$ 1 670 of office supplies on hand.
 - c. Estimated annual depreciation on the equipment is \$ 3 300.
 - d. Estimated annual depreciation on the professional library is \$ 1 320.
 - e. Community Technical School offers extended services to those in need of training beyond the campus. On November 1, the company agreed to provide in-home tutoring for a client. The contract calls for a \$ 600 monthly fee, and the client paid the first four months' fees in advance at the time the contract was signed. The amount paid was credited to the Unearned Extension Fees account.
 - f. On October 15, the school agreed to provide a three-month computer course for a local business for \$ 1 080 per month payable at the end of the class. Extension fees for two and one half months have accrued.
 - g. Every employee is paid weekly; and on December 31, three days' wages at \$ 70 per day have accrued.
3. After posting the adjusting entries, prepare an adjusted trial balance, an income statement, a statement of changes in owner's equity, and a classified balance sheet. Perry did not make additional investments in the business during the year.

Problem 3-2

The unadjusted trial balance of Eden's Garden follows:

EDEN's GARDEN

Trial Balance

December 31, 20×3

Cash	\$ 3 000	
Accounts receivable	1 400	
Landscaping supplies	1 680	
Prepaid insurance	3 200	
Investment in Sierra, Inc. , common stock (long-term)	6 000	
Trucks	42 000	
Accumulated depreciation, trucks		\$ 17 000

Landscaping equipment	5 700	
Accumulated depreciation, landscaping equipment		1 900
Building	68 000	
Accumulated depreciation, building		19 800
Land	16 000	
Franchise	30 000	
Unearned landscape architecture fees		1 050
Long-term notes payable		75 600
Eve Adams, capital		49 270
Eve Adams, withdrawals	27 000	
Landscape architecture fees earned		12 250
Landscaping services revenue		84 000
Office salaries expense	14 200	
Landscape wages expense	31 950	
Interest expense	6 800	
Gas, oil, and repair expense	3 940	
Totals	<u>\$ 260 870</u>	<u>\$ 260 870</u>

Required:

1. Set up accounts for the items in the trial balance plus these additional accounts: Wages Payable; Depreciation Expense, Building; Depreciation Expense, Trucks; Depreciation Expense, Landscaping Equipment; Insurance Expense; and Landscaping Supplies Expense. Enter the trial balance amounts in the accounts. Journalize and post adjusting entries given the following information:

- Insurance premiums of \$ 2 220 expired during the year.
- An inventory showed \$ 410 of unused landscaping supplies on hand.
- Estimated depreciation on the landscaping equipment, \$ 820.
- Estimated depreciation on the trucks, \$ 6 600.
- Estimated depreciation on the building, \$ 3 020.
- Of the \$ 1 050 credit balance in Unearned Landscape Architecture Fees, \$ 750 was earned by the year-end.
- Accrued landscape architecture fees earned but unrecorded at year-end totaled \$ 480.
- There were \$ 630 of earned but unrecorded landscape wages at the year-end.

2. Prepare an adjusted trial balance, an income statement for the year, a statement of changes in owner's equity, and a classified year-end balance sheet. Adams's capital ac-

count balance reflects the December 31, 20×2, balance plus a January 1, 20×3, investment of \$ 12 000. A \$ 9 000 installment on the notes payable is due within one year.

Problem 3–3

Foster Company's unadjusted trial balance and adjusted trial balance on December 31, 20×3, the end of its annual accounting period, appear as follows:

	Unadjusted		Adjusted	
	<u>Trial balance</u>		<u>Trial balance</u>	
Cash	\$ 15 450		\$ 15 450	
Accounts Receivable			3 050	
Office Supplies	1 320		480	
Prepaid insurance	2 400		1 200	
Office equipment	8 700		8 700	
Accumulated depreciation, office equipment		\$ 1 600		\$ 2 400
Accounts payable		720		1 130
Interest payable				1 230
Salaries payable				1 500
Unearned consulting fees		6 750		3 670
Long-term notes payable		7 300		7 300
Frank Foster, capital		8 470		8 470
Frank Foster, withdrawals	44 040		44 040	
Consulting fees earned		93 130		99 260
Depreciation expense, office equipment			800	
Salaries expense	28 100		29 600	
Interest expense			1 230	
Insurance expense			1 200	
Rent expense	13 500		13 500	
Office supplies expense			840	
Advertising expense	4 460		4 870	
Totals	<u>\$ 117 970</u>	<u>\$ 117 970</u>	<u>\$ 124 960</u>	<u>\$ 124 960</u>

Required:

Examine Foster Company's unadjusted and adjusted trial balances and prepare the year-end adjusting journal entries that Foster must have made. Your adjusting entries should explain the differences between the two trial balances.

Answers to Self-Test Questions:

1. d 2. a 3. b 4. b 5. d