



Feature Story: ACCIDENTS HAPPEN

How organized are you financially? Take a short quiz. Answer yes or no to each question:

- Does your wallet contain so many cash machine receipts that you've been declared a walking fire hazard?
- Is your wallet such a mess that it is often faster to fish for money in the crack of your car seat than to dig around in your wallet?
- Was Aaron Rodgers (the quarterback for the **Green Bay Packers**) playing high school football the last time you verified the accuracy of your bank account?

If you think it is hard to keep track of the many transactions that make up *your* life, imagine how difficult it is for a big corporation to do so. Not only that, but now consider how important it is for a big company to have good accounting records, especially if it has control of *your* life savings. **MF Global Holdings Ltd** is such a company. As a large investment broker, it held billions of dollars of investments for clients. If you had your life savings invested at MF Global, you might be slightly displeased if you heard this from one of its representatives: "You know, I kind of remember an account for someone with a name like yours—now what did we do with that?"

Unfortunately, that is almost exactly what happened to MF Global's clients shortly before it recently filed for bankruptcy. During the days immediately following the bankruptcy filing, regulators and auditors struggled to piece things together. In the words of one regulator, "Their books are a disaster ... we're trying to figure out what numbers are real numbers." One company that considered buying an interest in MF Global walked away from the deal because it "couldn't get a sense of what was on the balance sheet." That company said the information that should have been instantly available instead took days to produce.

It now appears that MF Global did not properly segregate customer accounts from company accounts. And, because of its sloppy record-keeping, customers were not protected when the company had financial troubles. Total customer losses were approximately \$1 billion. As you can see, accounting matters!



Source: S. Patterson and A. Lucchetti, "Inside the Hunt for MF Global Cash," *Wall Street Journal Online* (November 11, 2011).

INSIDE CHAPTER 3...

- ● **Why Accuracy Matters** ([p. 109](#))
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PREVIEW OF CHAPTER 3

As indicated in the Feature Story, a reliable information system is a necessity for any company. The purpose of this chapter is to explain and illustrate the features of an accounting information system. The organization and content of the chapter are as follows.

The Accounting Information System



The Accounting Information System

The system of collecting and processing transaction data and communicating financial information to decision-makers is known as the [accounting information system](#). Factors that shape an accounting information system include the nature of the company’s business, the types of transactions, the size of the company, the volume of data, and the information demands of management and others.

LEARNING OBJECTIVE 1

Analyze the effect of business transactions on the basic accounting equation.

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** states, “We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area.” In addition, many companies have upgraded their accounting information systems in response to the requirements of Sarbanes-Oxley.

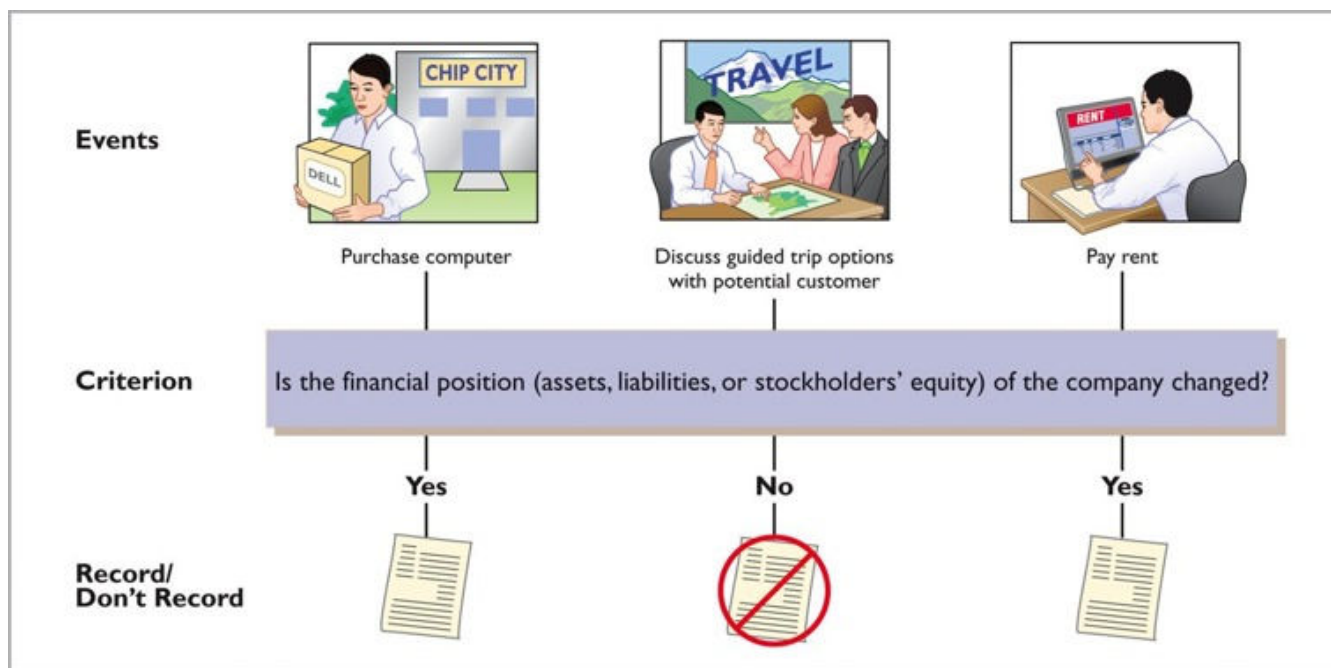
In this chapter, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

ACCOUNTING TRANSACTIONS

To use an accounting information system, you need to know which economic events to recognize (record). Not all events are recorded and reported in the financial statements. For example, suppose **General Motors** hired a new employee and purchased a new computer. Are these events entered in its accounting records? The first event would not be recorded, but the second event would. We call economic events that require recording in the financial statements [accounting transactions](#).

An accounting transaction occurs when assets, liabilities, or stockholders’ equity items change as a result of some economic event. The purchase of a computer by **General Motors**, the payment of rent by **Microsoft**, and the sale of a multi-day guided trip by Sierra Corporation are examples of events that change a company’s assets, liabilities, or stockholders’ equity. [Illustration 3-1](#) summarizes the decision process companies use to decide whether or not to record economic events.

Illustration 3-1: Transaction identification process



ANALYZING TRANSACTIONS

In [Chapter 1](#), you learned the basic accounting equation:

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

In this chapter, you will learn how to analyze transactions in terms of their effect on assets, liabilities, and stockholders' equity. **Transaction analysis** is the process of identifying the specific effects of economic events on the accounting equation.

The accounting equation must always balance. Each transaction has a dual (double-sided) effect on the equation. For example, if an individual asset is increased, there must be a corresponding:

- Decrease in another asset, *or*
- Increase in a specific liability, *or*
- Increase in stockholders' equity.

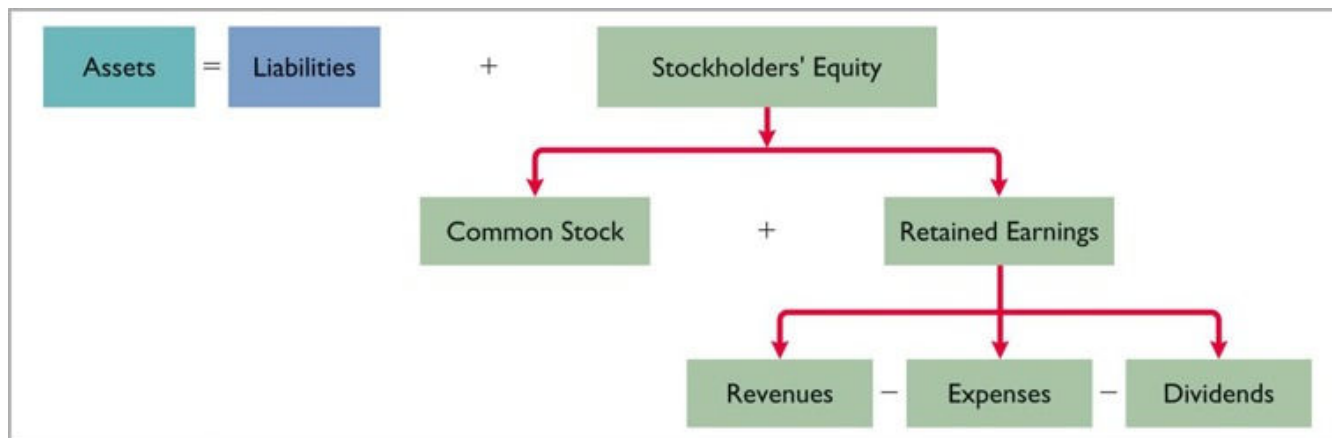
Two or more items could be affected when an asset is increased. For example, if a company purchases a computer for \$10,000 by paying \$6,000 in cash and signing a note for \$4,000, one asset (equipment) increases \$10,000, another asset (cash) decreases \$6,000, and a liability (notes payable) increases \$4,000. The result is that the accounting equation remains in balance—assets increased by a net \$4,000 and liabilities increased by \$4,000, as shown below.

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
+\$10,000		+\$4,000		
- 6,000				
<hr/> \$ 4,000	=	<hr/> \$4,000		

[Chapter 1](#) presented the financial statements for Sierra Corporation for its first month. You should review those financial statements (on [pages 12–15](#)) at this time. To illustrate how economic events affect the accounting equation, we will examine events affecting Sierra Corporation during its first month.

In order to analyze the transactions for Sierra Corporation, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on stockholders' equity. Recall from the balance sheets in [Chapters 1](#) and [2](#) that stockholders' equity is comprised of two parts: common stock and retained earnings. Common stock is affected when the

Illustration 3-2: Expanded accounting equation



If you are tempted to skip ahead after you’ve read a few of the following transaction analyses, don’t do it. Each has something unique to teach, something you’ll need later. (We assure you that we’ve kept them to the minimum needed!)

EVENT (1). INVESTMENT OF CASH BY STOCKHOLDERS.

On October 1, cash of \$10,000 is invested in the business by investors (primarily your friends and family) in exchange for \$10,000 of common stock. This event is an accounting transaction because it results in an increase in both assets and stockholders’ equity.

Basic Analysis	The asset Cash is increased \$10,000; stockholders’ equity (specifically Common Stock) is increased \$10,000.															
Equation Analysis	<table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center; border-bottom: 1px solid black;">Assets</th> <th style="text-align: center;">=</th> <th style="text-align: center; border-bottom: 1px solid black;">Liabilities</th> <th style="text-align: center;">+</th> <th style="text-align: center; border-bottom: 1px solid black;">Stockholders’ Equity</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Cash</td> <td style="text-align: center;">=</td> <td></td> <td></td> <td style="text-align: center;">Common Stock</td> </tr> <tr style="color: red;"> <td style="text-align: center;">(1) +\$10,000</td> <td></td> <td></td> <td></td> <td style="text-align: center;">+\$10,000 Issued stock</td> </tr> </tbody> </table>	Assets	=	Liabilities	+	Stockholders’ Equity	Cash	=			Common Stock	(1) +\$10,000				+\$10,000 Issued stock
Assets	=	Liabilities	+	Stockholders’ Equity												
Cash	=			Common Stock												
(1) +\$10,000				+\$10,000 Issued stock												

The equation is in balance after the issuance of common stock. Keeping track of the source of each change in stockholders’ equity is essential for later accounting activities. In particular, items recorded in the revenue and expense columns are used for the calculation of net income.

EVENT (2). NOTE ISSUED IN EXCHANGE FOR CASH.

On October 1, Sierra borrowed \$5,000 from Castle Bank by signing a 3-month, 12%, \$5,000 note payable. This transaction results in an equal increase in assets and liabilities. The specific effect of this transaction and the cumulative effect of the first two transactions are:

Basic Analysis

The asset Cash is increased \$5,000; the liability Notes Payable is increased \$5,000.

Equation Analysis

Assets		=	Liabilities	+	Stockholders' Equity
Cash		=	Notes Payable	+	Common Stock
\$10,000					\$10,000
(2) +5,000			+5,000		
\$15,000		=	\$5,000	+	\$10,000
			\$15,000		

Total assets are now \$15,000, and liabilities plus stockholders' equity also total \$15,000.

EVENT (3). PURCHASE OF OFFICE EQUIPMENT FOR CASH.

On October 2, Sierra purchased equipment by paying \$5,000 cash to Superior Equipment Sales Co. This event is a transaction because an equal increase and decrease in Sierra's assets occur. The total assets are now \$15,000, and liabilities plus stockholders' equity also total \$15,000.

Basic Analysis

The asset Equipment is increased \$5,000; the asset Cash is decreased \$5,000.

Equation Analysis

Assets		=	Liabilities	+	Stockholders' Equity
Cash	+ Equipment	=	Notes Payable	+	Common Stock
\$15,000			\$5,000		\$10,000
(3) -5,000	+5,000				
\$10,000	+ \$5,000	=	\$5,000	+	\$10,000
\$15,000			\$15,000		

EVENT (4). RECEIPT OF CASH IN ADVANCE FROM CUSTOMER.

On October 2, Sierra received a \$1,200 cash advance from R. Knox, a client. This event is a transaction because Sierra received cash (an asset) for guide services for multi-day trips that are expected to be completed by Sierra in the future. Although Sierra received cash, **it does not record revenue until it has performed the work**. In some industries, such as the magazine and airline industries, customers are expected to prepay. These companies have a liability to the customer until they deliver the magazines or provide the flight. When the company eventually provides the product or service, it records the revenue.

Since Sierra received cash prior to performance of the service, Sierra has a liability for the work due.

Basic Analysis

The asset Cash is increased \$1,200; the liability Unearned Service Revenue is increased \$1,200 because the service has not been performed yet. That is, when an advance payment is received, an unearned revenue (a liability) should be recorded in order to recognize the obligation that exists.

work may be

Equation Analysis

Assets		=	Liabilities		+	Stockholders' Equity		
Cash	+	Equip-ment	=	Notes Payable	+	Unearned Service Revenue	+	Common Stock
\$10,000		\$5,000	=	\$5,000				\$10,000
(4) +1,200			=			+1,200		
\$11,200	+	\$5,000	=	\$5,000	+	\$1,200	+	\$10,000
\$16,200				\$16,200				

EVENT (5). SERVICES PERFORMED FOR CASH.

On October 3, Sierra received \$10,000 in cash from Copa Company for guide services performed for a corporate event. This event is a transaction because Sierra received an asset (cash) in exchange for services.

Guide service is the principal revenue-producing activity of Sierra. **Revenue increases stockholders' equity.** This transaction, then, increases both assets and stockholders' equity.

Basic Analysis

The asset Cash is increased \$10,000; the revenue Service Revenue is increased \$10,000.

Equation Analysis

Assets		=	Liabilities		+	Stockholders' Equity								
Cash	+	Equip-ment	=	Notes Pay.	+	Unearned Serv. Rev.	+	Common Stock	+	Retained Earnings				
										Rev.	-	Exp.	-	Div.
\$11,200		\$5,000	=	\$5,000		\$1,200		\$10,000						
(5) +10,000			=							+10,000				
\$21,200	+	\$5,000	=	\$5,000	+	\$1,200	+	\$10,000	+	\$10,000				
\$26,200				\$26,200										

Often companies perform services "on account." That is, they perform services for which they are paid at a later date. Revenue, however, is recorded when services are performed. Therefore, revenues would increase when services are performed, even though cash has not been received. Instead of receiving cash, the company receives a different type of asset, an **account receivable**. Accounts receivable represent the right to receive payment at a later date. Suppose that Sierra had provided these services on account rather than for cash. This event would be reported using the accounting equation as:

Assets		=	Liabilities		+	Stockholders' Equity	
Accounts Receivable	=					Revenues	
+10,000						+10,000	Service Revenue

Later, when Sierra collects the \$10,000 from the customer, Accounts Receivable decreases by \$10,000, and Cash increases by \$10,000.

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	Accounts Receivable						
+\$10,000	-\$10,000						

Note that in this case, revenues are not affected by the collection of cash. Instead we record an exchange of one asset (Accounts Receivable) for a different asset (Cash).

EVENT (6). PAYMENT OF RENT.

On October 3, Sierra Corporation paid its office rent for the month of October in cash, \$900. This rent payment is a transaction because it results in a decrease in an asset, cash.

Rent is a cost incurred by Sierra Corporation in its effort to generate revenues. It is treated as an expense because it pertains only to the current month. **Expenses decrease stockholders' equity.** Sierra records the rent payment by decreasing cash and increasing expenses to maintain the balance of the accounting equation.

Basic Analysis	The expense account Rent Expense is increased \$900 because the payment pertains only to the current month; the asset Cash is decreased \$900.								
Equation Analysis									
Assets		=	Liabilities		+	Stockholders' Equity			
Cash	+ Equip- ment		Notes Pay.	+ Unearned Serv. Rev.		Common Stock	Retained Earnings		
\$21,200	\$5,000		\$5,000	\$1,200		\$10,000	\$10,000	-	-
(6) -900							-900	Rent	Expense
\$20,300	+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	+ \$10,000	-	\$900
\$25,300			\$25,300						

EVENT (7). PURCHASE OF INSURANCE POLICY FOR CASH.

On October 4, Sierra paid \$600 for a one-year insurance policy that will expire next year on September 30. Payments of expenses that will benefit more than one accounting period are identified as assets called prepaid expenses or prepayments.

Basic Analysis	The asset Cash is decreased \$600; the asset Prepaid Insurance is increased \$600.									
Equation Analysis										
Assets			=	Liabilities		+	Stockholders' Equity			
Cash	+ Prepaid Insurance	+ Equip- ment		Notes Pay.	+ Unearned Serv. Rev.		Common Stock	Retained Earnings		
\$20,300		\$5,000		\$5,000	\$1,200		\$10,000	\$10,000	\$900	
(7) -600	+600									
\$19,700	+ \$600	+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	+ \$10,000	-	\$900
\$25,300				\$25,300						

The balance in total assets did not change; one asset account decreased by the same amount that another increased.

EVENT (8). PURCHASE OF SUPPLIES ON ACCOUNT.

On October 5, Sierra purchased an estimated three months of supplies on account from Aero Supply for \$2,500. In this case, "on account" means that the company receives goods or services that it will pay for at a later date.

Basic Analysis The asset Supplies is increased \$2,500; the liability Accounts Payable is increased \$2,500.

Equation Analysis

Assets				=	Liabilities			+	Stockholders' Equity									
Cash	Supplies	Prepd. Insur.	Equip-ment	=	Notes Pay.	Accounts Payable	Unearned Serv. Rev.	+	Common Stock	Retained Earnings	Rev.	Exp.	Div.					
\$19,700		\$600	\$5,000	=	\$5,000		\$1,200	+	\$10,000	\$10,000		\$900						
(8)	+\$2,500			=		+\$2,500												
\$19,700	+	\$2,500	+	\$600	+	\$5,000	=	\$5,000	+	\$2,500	+	\$1,200	+	\$10,000	+	\$10,000	-	\$900
\$27,800					\$27,800													

EVENT (9). HIRING OF NEW EMPLOYEES.

On October 9, Sierra hired four new employees to begin work on October 15. Each employee will receive a weekly salary of \$500 for a five-day work week, payable every two weeks. Employees will receive their first paychecks on October 26. On the date Sierra hires the employees, there is no effect on the accounting equation because the assets, liabilities, and stockholders' equity of the company have not changed.

Basic Analysis An accounting transaction has not occurred. There is only an agreement that the employees will begin work on October 15. (See Event (11) for the first payment.)

EVENT (10). PAYMENT OF DIVIDEND.

On October 20, Sierra paid a \$500 dividend. **Dividends** are a reduction of stockholders' equity but not an expense. Dividends are not included in the calculation of net income. Instead, a dividend is a distribution of the company's assets to its stockholders.

Basic Analysis The dividends account is increased \$500; the asset Cash is decreased \$500.

Equation Analysis

Assets				=	Liabilities			+	Stockholders' Equity											
Cash	Sup-plies	Prepd. Insur.	Equip-ment	=	Notes Pay.	Accts. Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings	Rev.	Exp.	Div.							
\$19,700		\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	\$10,000		\$900								
(10)	-500			=									- \$500							
\$19,200	+	\$2,500	+	\$600	+	\$5,000	=	\$5,000	+	\$2,500	+	\$1,200	+	\$10,000	+	\$10,000	-	\$900	-	\$500
\$27,300					\$27,300															

EVENT (11). PAYMENT OF CASH FOR EMPLOYEE SALARIES.

Employees have worked two weeks, earning \$4,000 in salaries, which were paid on October 26. Salaries and Wages Expense is an expense that reduces stockholders' equity. This event is a transaction because assets and stockholders' equity are affected.

Basic Analysis

The asset Cash is decreased \$4,000; the expense account Salaries and Wages Expense is increased \$4,000.

Work may be

Equation Analysis

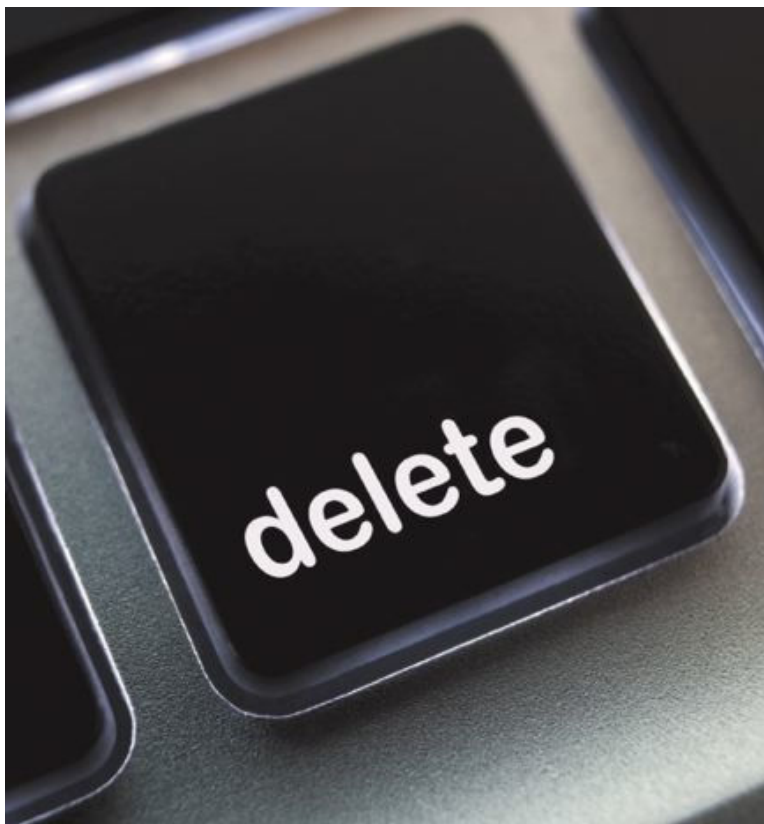
Assets				=	Liabilities			+	Stockholders' Equity			
Cash	Supplies	Prepd. Insur.	Equip-ment	=	Notes Pay.	Accts. Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings		
										Rev.	- Exp.	- Div.
\$19,200	\$2,500	\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	\$10,000	\$ 900	\$500
(11) -4,000				=							- 4,000	
\$15,200	\$2,500	\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	\$10,000	- \$4,900	- \$500
\$23,300									\$23,300			

Sal./Wages Expense



Investor Insight: Why Accuracy Matters

While most companies record transactions very carefully, the reality is that mistakes still happen. For example, bank regulators fined **Bank One Corporation** (now **JPMorgan Chase**) \$1.8 million because they felt that the unreliability of the bank's accounting system caused it to violate regulatory requirements.



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Also, in recent years **Fannie Mae**, the government-chartered mortgage association, announced a series of large accounting errors. These announcements caused alarm among investors, regulators, and politicians because they fear that the errors may suggest larger, undetected problems. This is important because the home-mortgage market depends on Fannie Mae to buy hundreds of billions of dollars of mortgages each year from banks, thus enabling the banks to issue new mortgages.

Finally, before a major overhaul of its accounting system, the financial records of **Waste Management Company** were in such disarray that of the company's 57,000 employees, 10,000 were receiving pay slips that were in error.



In order for these companies to prepare and issue financial statements, their accounting equations (debits and credits) must have been in balance at year-end. How could these errors or misstatements have occurred? (See [page 159](#).)

SUMMARY OF TRANSACTIONS

[Illustration 3-3](#) ([page 110](#)) summarizes the transactions of Sierra Corporation to show their cumulative effect on the basic accounting equation. It includes the transaction number in the first column on the left. The right-most column shows the specific effect of any transaction that affects stockholders' equity. Remember that Event (9) did not result in a transaction, so no entry is included for that event. The illustration demonstrates three important points:

- 1. Each transaction is analyzed in terms of its effect on assets, liabilities, and stockholders' equity.
- 2. The two sides of the equation must always be equal.
- 3. The cause of each change in stockholders' equity must be indicated.

Illustration 3-3: Summary of transactions

	Assets				=	Liabilities			+	Stockholders' Equity				
	Cash	Supplies	Prepd. Insur.	Equip-ment	=	Notes Pay.	Accts. Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings			
											Rev.	- Exp.	- Div.	
(1)	+\$10,000				=					+\$10,000				Issued stock
(2)	+5,000					+\$5,000								
(3)	-5,000			+\$5,000										
(4)	+1,200							+\$1,200						
(5)	+10,000									+\$10,000				Service Revenue
(6)	-900											-\$ 900		Rent Expense
(7)	-600		+\$600											
(8)		+\$2,500					+\$2,500							
(10)	-500												-\$500	Dividends
(11)	-4,000											-4,000		Sal/Wages Expense
	<u>\$15,200</u>	<u>+\$2,500</u>	<u>+\$600</u>	<u>+\$5,000</u>	=	<u>\$5,000</u>	<u>+\$2,500</u>	<u>+\$1,200</u>		<u>+\$10,000</u>	<u>+\$10,000</u>	<u>-\$4,900</u>	<u>-\$500</u>	
	\$23,300					\$23,300								



TOOLKIT

DECISION

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Has an accounting transaction occurred?	Details of the event	Accounting equation	If the event affected assets, liabilities, or stockholders' equity, then record as a transaction.

Do it! TRANSACTION ANALYSIS

A tabular analysis of the transactions made by Roberta Mendez & Co., a certified public accounting firm, for the month of August is shown below. Each increase and decrease in stockholders' equity is explained. Describe each transaction that occurred for the month.

Assets		=	Liabilities	+	Stockholders' Equity			
Cash	+ Equipment	=	Accounts Payable	+	Common Stock	+ Revenue	- Expenses	
1. +\$25,000		=		+	+\$25,000			Issued stock
2.	+ \$7,000	=	+ \$7,000					
3. +8,000						+ \$8,000		Service Revenue
4. -850							- \$850	Rent Expense
<u>\$32,150</u>	<u>+ \$7,000</u>	=	<u>\$7,000</u>	+	<u>\$25,000</u>	<u>+ \$8,000</u>	<u>- \$850</u>	
\$39,150						\$39,150		

Action Plan

- Analyze the tabular analysis to determine the nature and effect of each transaction.
- Keep the accounting equation in balance.
- Remember that a change in an asset will require a change in another asset, a liability, or in stockholders' equity.

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- 1. The company issued shares of stock to stockholders for \$25,000 cash.
- 2. The company purchased \$7,000 of equipment on account.
- 3. The company received \$8,000 of cash in exchange for services performed.
- 4. The company paid \$850 for this month's rent.

Related exercise material: [BE3-1](#), [BE3-2](#), [BE3-3](#), **Do it!** [3-1](#), [E3-1](#), [E3-2](#), [E3-3](#), and [E3-4](#).



The Account

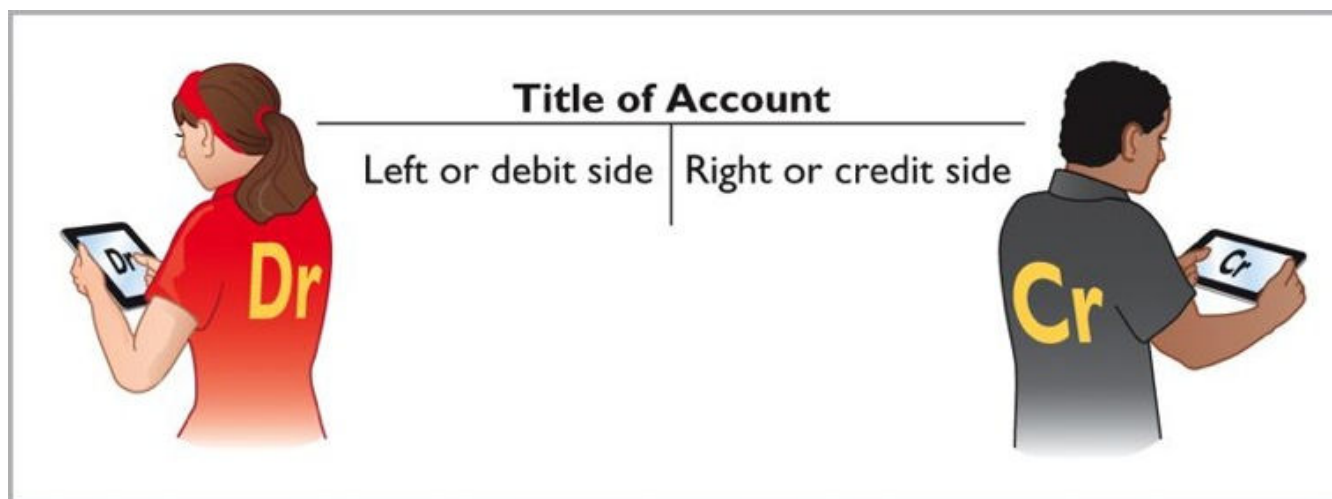
Rather than using a tabular summary like the one in [Illustration 3-3](#) for Sierra Corporation, an accounting information system uses accounts. An **account** is an individual accounting record of increases and decreases in a specific asset, liability, stockholders' equity, revenue, or expense item. For example, Sierra Corporation has separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries and Wages Expense, and so on. (Note that whenever we are referring to a specific account, we capitalize the name.)

LEARNING OBJECTIVE 2

Explain what an account is and how it helps in the recording process.

In its simplest form, an account consists of three parts: (1) the title of the account, (2) a left or debit side, and (3) a right or credit side. Because the alignment of these parts of an account resembles the letter T, it is referred to as a **T-account**. The basic form of an account is shown in [Illustration 3-4](#).

Illustration 3-4: Basic form of account



We use this form of account often throughout this book to explain basic accounting relationships.

DEBITS AND CREDITS

The term **debit** indicates the left side of an account, and **credit** indicates the right side. They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They **do not** mean increase or decrease, as is commonly thought. We use the terms debit and credit

LEARNING OBJECTIVE 3

Define debits and credits and explain how they are used to record business transactions.

When comparing the totals of the two sides, an account shows a **debit balance** if the total of the debit amounts exceeds the credits. An account shows a **credit balance** if the credit amounts exceed the debits. Note the position of the debit side and credit side in [Illustration 3-4](#).

The procedure of recording debits and credits in an account is shown in [Illustration 3-5](#) for the transactions affecting the Cash account of Sierra Corporation. The data are taken from the Cash column of the tabular summary in [Illustration 3-3](#).

Illustration 3-5: Tabular summary and account form for Sierra Corporation's Cash account

Tabular Summary		Account Form	
Cash		Cash	
\$10,000		(Debits) 10,000	(Credits) 5,000
5,000		5,000	900
-5,000		1,200	600
1,200		10,000	500
10,000			4,000
-900			
-600			
-500			
-4,000			
<u>\$15,200</u>		Balance 15,200	
		(Debit)	

Every positive item in the tabular summary represents a receipt of cash; every negative amount represents a payment of cash. **Notice that in the account form we record the increases in cash as debits, and the decreases in cash as credits.** For example, the \$10,000 receipt of cash (in red) is debited to Cash, and the -\$5,000 payment of cash (in blue) is credited to Cash.

Having increases on one side and decreases on the other reduces recording errors and helps in determining the totals of each side of the account as well as the account balance. The balance is determined by netting the two sides (subtracting one amount from the other). The account balance, a debit of \$15,200, indicates that Sierra had \$15,200 more increases than decreases in cash. That is, since it started with a balance of zero, it has \$15,200 in its Cash account.

DEBIT AND CREDIT PROCEDURES

Each transaction must affect two or more accounts to keep the basic accounting equation in balance. In other words, **for each transaction, debits must equal credits.** The equality of debits and credits provides the basis for the double-entry accounting system.

Under the [double-entry system](#), the two-sided effect of each transaction is recorded in appropriate accounts. This system provides a logical method for recording transactions. The double-entry system also helps to ensure the accuracy of the recorded amounts and helps to detect errors such as those at **MF Global** as discussed in the Feature Story. If every transaction is recorded with equal debits and credits, then the sum of all the debits to the accounts must equal the sum of all the credits. The double-entry system for determining the equality of the accounting equation is much more efficient than the plus/minus procedure used earlier.

International Note

Dr./Cr. Procedures for Assets and Liabilities

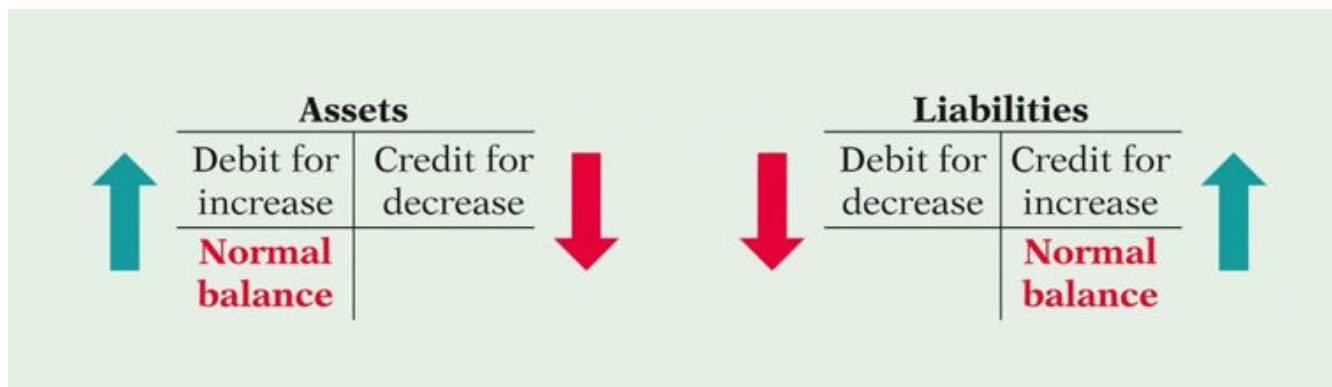
In [Illustration 3-5](#) for Sierra Corporation, increases in Cash—an asset—were entered on the left side, and decreases in Cash were entered on the right side. We know that both sides of the basic equation (Assets = Liabilities + Stockholders' Equity) must be equal. It therefore follows that increases and decreases in liabilities will have to be recorded **opposite from** increases and decreases in assets. Thus, increases in liabilities must be entered on the right or credit side, and decreases in liabilities must be entered on the left or debit side. The effects that debits and credits have on assets and liabilities are summarized in [Illustration 3-6](#).

Illustration 3-6: Debit and credit effects—assets and liabilities

Debits	Credits
Increase assets	Decrease assets
Decrease liabilities	Increase liabilities

Asset accounts normally show debit balances. That is, debits to a specific asset account should exceed credits to that account. Likewise, **liability accounts normally show credit balances.** That is, credits to a liability account should exceed debits to that account. The **normal balances** may be diagrammed as in [Illustration 3-7](#).

Illustration 3-7: Normal balances—assets and liabilities



Knowing which is the normal balance in an account may help when you are trying to identify errors. For example, a credit balance in an asset account, such as Land, or a debit balance in a liability account, such as Salaries and Wages Payable, usually indicates errors in recording. Occasionally, however, an abnormal balance may be correct. The Cash account, for example, will have a credit balance when a company has overdrawn its bank balance (written a check that “bounced”). In automated accounting systems, the computer is programmed to flag violations of the normal balance and to print out error or exception reports. In manual systems, careful visual inspection of the accounts is required to detect normal balance problems.

Helpful Hint

The normal balance is the side where increases in the account are recorded.

Dr./Cr. Procedures for Stockholders' Equity

Chapter 1 we indicated that stockholders' equity is comprised of two parts: common stock and retained earnings. In the transaction events earlier in this chapter, you saw that revenues, expenses, and the payment of dividends affect retained earnings. Therefore, the subdivisions of stockholders' equity are common stock, retained earnings, dividends, revenues, and expenses.

COMMON STOCK.

Common stock is issued to investors in exchange for the stockholders' investment. The Common Stock account is increased by credits and decreased by debits. For example, when cash is invested in the business, Cash is debited and Common Stock is credited. The effects of debits and credits on the Common Stock account are shown in [Illustration 3-8](#).

Illustration 3-8: Debit and credit effects—Common Stock

Debits	Credits
Decrease Common Stock	Increase Common Stock

The normal balance in the Common Stock account may be diagrammed as in [Illustration 3-9](#).

Illustration 3-9: Normal balance—Common Stock



RETAINED EARNINGS.

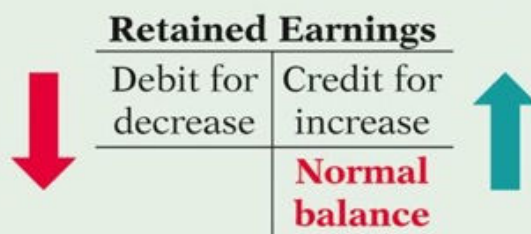
Retained earnings is net income that is retained in the business. It represents the portion of stockholders' equity that has been accumulated through the profitable operation of the company. Retained Earnings is increased by credits (for example, by net income) and decreased by debits (for example, by a net loss), as shown in [Illustration 3-10](#).

Illustration 3-10: Debit and credit effects—Retained Earnings

Debits	Credits
Decrease Retained Earnings	Increase Retained Earnings

The normal balance for Retained Earnings may be diagrammed as in [Illustration 3-11](#).

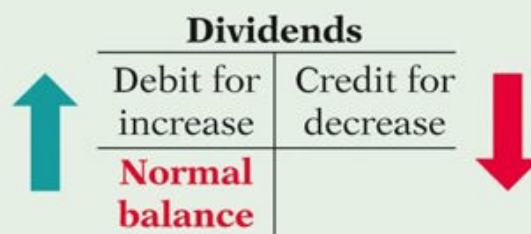
Illustration 3-11: Normal balance—Retained Earnings



DIVIDENDS.

A dividend is a distribution by a corporation to its stockholders. The most common form of distribution is a cash dividend. Dividends result in a reduction of the stockholders' claims on retained earnings. Because dividends reduce stockholders' equity, increases in the Dividends account are recorded with debits. As shown in [Illustration 3-12](#), the Dividends account normally has a debit balance.

Illustration 3-12: Normal balance—Dividends



REVENUES AND EXPENSES.

When a company recognizes revenues, stockholders' equity is increased. Revenue accounts are increased by credits and decreased by debits.

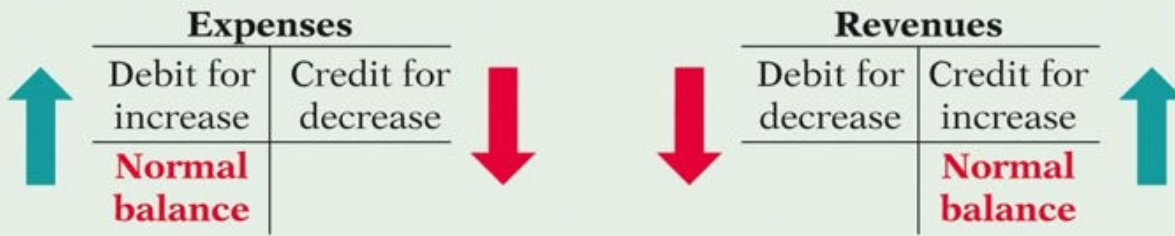
Expenses decrease stockholders' equity. Thus, expense accounts are increased by debits and decreased by credits. The effects of debits and credits on revenues and expenses are shown in [Illustration 3-13](#).

Illustration 3-13: Debit and credit effects—revenues and expenses

Debits	Credits
Decrease revenue	Increase revenue
Increase expenses	Decrease expenses

Credits to revenue accounts should exceed debits; debits to expense accounts should exceed credits. Thus, **revenue accounts normally show credit balances, and expense accounts normally show debit balances.** The normal balances may be diagrammed as in [Illustration 3-14](#).

Illustration 3-14: Normal balances—revenues and expenses



Investor Insight: Keeping Score

The **Chicago Cubs** baseball team has these major revenue and expense accounts:



© Jonathan Daniel/Getty Images, Inc.

Revenues

Expenses

Admissions (ticket sales)

Players' salaries

Revenues	Expenses
Concessions	Administrative salaries
Television and radio	Travel
Advertising	Ballpark maintenance



Do you think that the **Chicago Bears** football team would be likely to have the same major revenue and expense accounts as the Cubs? (See [page 159](#).)

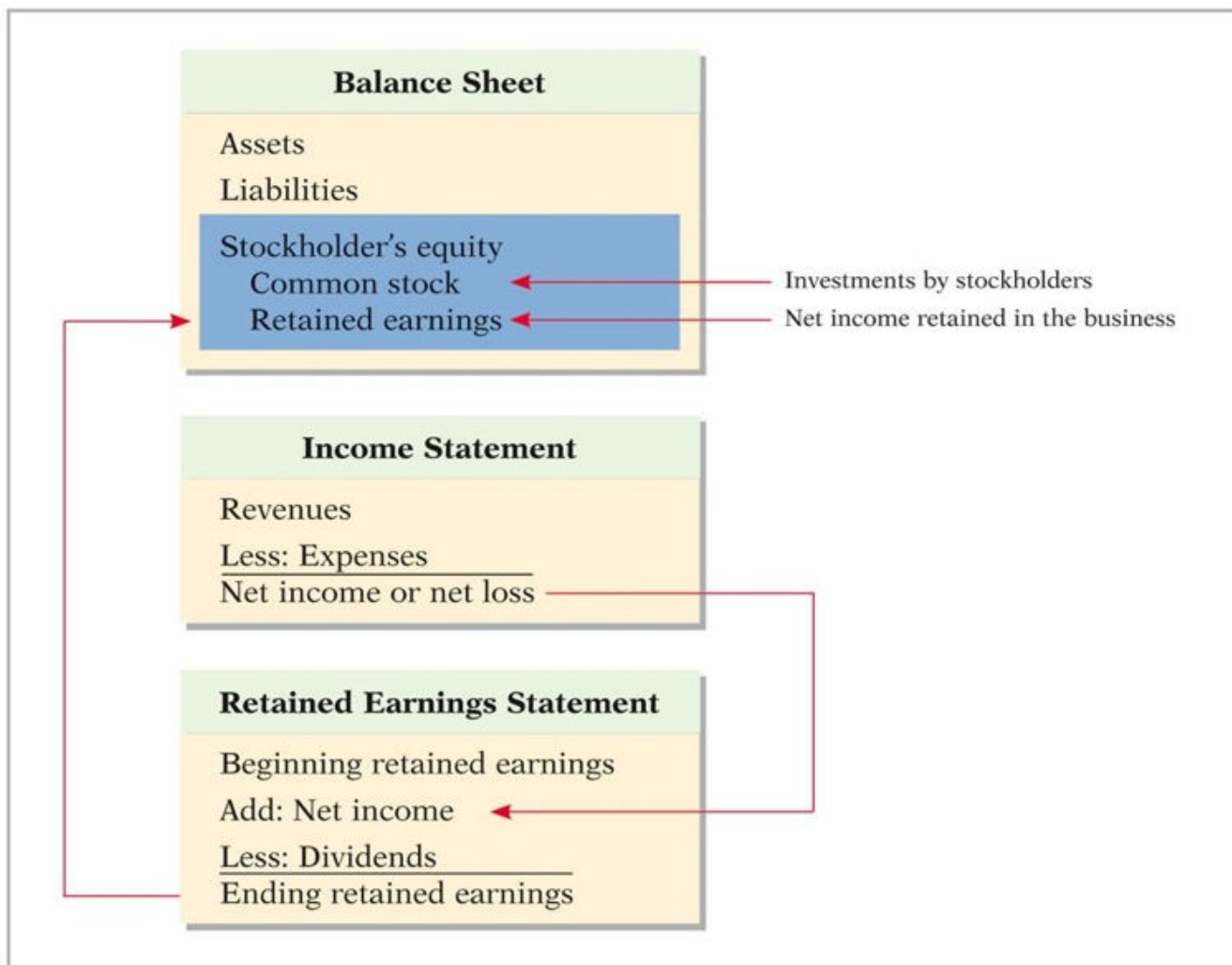
STOCKHOLDERS' EQUITY RELATIONSHIPS

Companies report the subdivisions of stockholders' equity in various places in the financial statements:

- Common stock and retained earnings: in the stockholders' equity section of the balance sheet.
- Dividends: on the retained earnings statement.
- Revenues and expenses: on the income statement.

Dividends, revenues, and expenses are eventually transferred to retained earnings at the end of the period. As a result, a change in any one of these three items affects stockholders' equity. [Illustration 3-15](#) shows the relationships of the accounts affecting stockholders' equity.

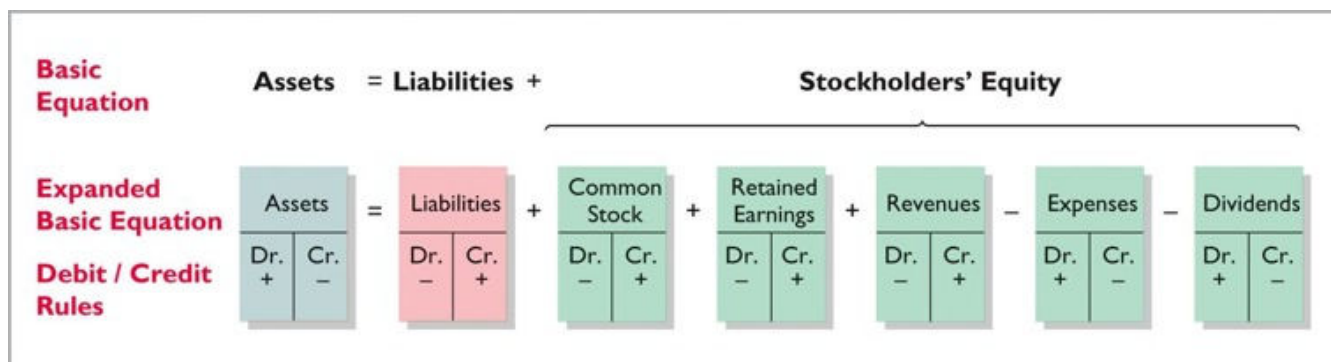
Illustration 3-15: Stockholders' equity relationships



SUMMARY OF DEBIT/CREDIT RULES

[Illustration 3-16](#) summarizes the debit/credit rules and effects on each type of account. **Study this diagram carefully.** It will help you understand the fundamentals of the double-entry system. No matter what the transaction, total debits must equal total credits in order to keep the accounting equation in balance.

Illustration 3-16: Summary of debit/credit rules



Do it! DEBITS AND CREDITS FOR BALANCE SHEET ACCOUNTS

Kate Browne, president of Hair It Is Inc., has just rented space in a shopping mall for the purpose of opening and operating a beauty salon. Long before opening day and before purchasing equipment, hiring assistants, and remodeling the space, Kate was

strongly advised to set up a double-entry set of accounting records in which to record all of her business transactions.
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Identify the balance sheet accounts that Hair It Is Inc. will likely need to record the transactions necessary to establish and open for business. Also, indicate whether the normal balance of each account is a debit or a credit.

Action Plan

- First identify asset accounts for each different type of asset invested in the business.
- Then identify liability accounts for debts incurred by the business.
- Hair It Is Inc. needs only one stockholders' equity account, Common Stock, when it begins the business. The other stockholders' equity account, Retained Earnings, will be needed after the business is operating.

Solution

Hair It Is Inc. would likely need the following accounts in which to record the transactions necessary to establish and ready the beauty salon for opening day: Cash (debit balance); Equipment (debit balance); Supplies (debit balance); Accounts Payable (credit balance); Notes Payable (credit balance), if the business borrows money; and Common Stock (credit balance).

Related exercise material: [BE3-4](#), [BE3-5](#),  [3-2](#), and [E3-7](#).



Steps in the Recording Process

Although it is possible to enter transaction information directly into the accounts, few businesses do so. Practically every business uses these basic steps in the recording process:

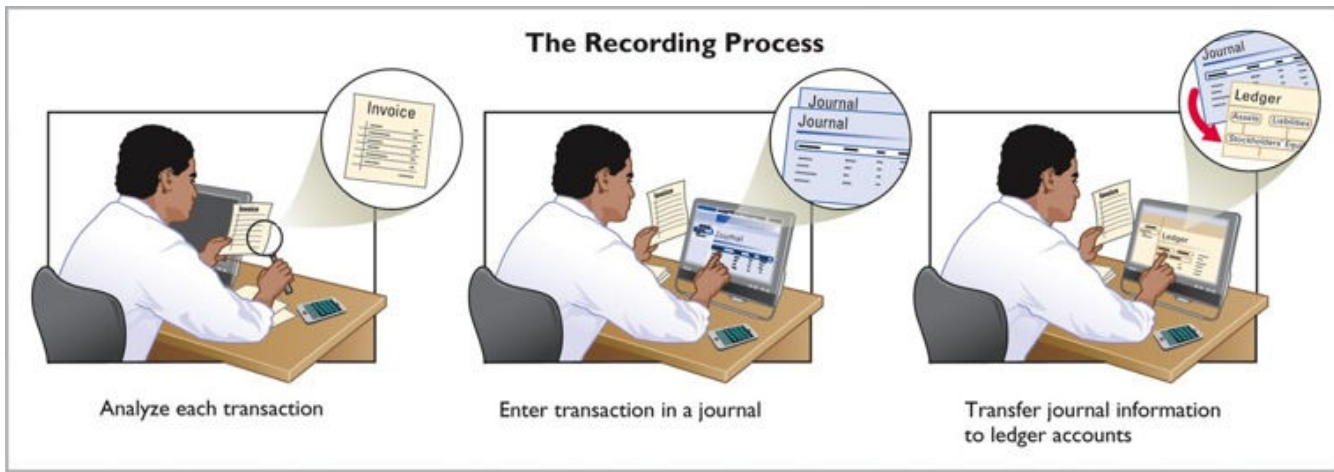
LEARNING OBJECTIVE 4

Identify the basic steps in the recording process.

1. Analyze each transaction in terms of its effect on the accounts.
2. Enter the transaction information in a journal.
3. Transfer the journal information to the appropriate accounts in the ledger.

The actual sequence of events begins with the transaction. Evidence of the transaction comes in the form of a **source document**, such as a sales slip, a check, a bill, or a cash register document. This evidence is analyzed to determine the effect of the transaction on specific accounts. The transaction is then entered in the **journal**. Finally, the journal entry is transferred to the designated accounts in the **ledger**. The sequence of events in the recording process is shown in [Illustration 3-17](#).

Illustration 3-17: The recording process



Ethics Note

Business documents provide evidence that transactions actually occurred. **International Outsourcing Services, LLC**, was accused of submitting fraudulent documents (store coupons) to companies such as **Kraft Foods** and **PepsiCo** for reimbursement of as much as \$250 million. Ensuring that all recorded transactions are backed up by proper business documents reduces the likelihood of fraudulent activity.

THE JOURNAL

Transactions are initially recorded in chronological order in **journals** before they are transferred to the accounts. For each transaction, the journal shows the debit and credit effects on specific accounts. (In a computerized system, journals are kept as files, and accounts are recorded in computer databases.)

LEARNING OBJECTIVE 5

Explain what a journal is and how it helps in the recording process.

Companies may use various kinds of journals, but every company has at least the most basic form of journal, a **general journal**. **The journal makes three significant contributions to the recording process:**

- 1. It discloses in one place the **complete effect of a transaction**.
- 2. It provides a **chronological record** of transactions.
- 3. It **helps to prevent or locate errors** because the debit and credit amounts for each entry can be readily compared.

Entering transaction data in the journal is known as **journalizing**. To illustrate the technique of journalizing, let's look at the first three transactions of Sierra Corporation in equation form.

On October 1, Sierra issued common stock in exchange for \$10,000 cash:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Cash	=			Common Stock
+\$10,000				+\$10,000 Issued stock

On October 1, Sierra borrowed \$5,000 by signing a note:

$$\begin{array}{rcl}
 \underline{\text{Assets}} & = & \underline{\text{Liabilities}} + \underline{\text{Stockholders' Equity}} \\
 \text{Cash} & = & \text{Notes Payable} \\
 +\$5,000 & & +\$5,000
 \end{array}$$

On October 2, Sierra purchased equipment for \$5,000:

$$\begin{array}{rcl}
 \underline{\text{Assets}} & = & \underline{\text{Liabilities}} + \underline{\text{Stockholders' Equity}} \\
 \text{Cash} & \text{Equipment} & \\
 -\$5,000 & +\$5,000 &
 \end{array}$$

Sierra makes separate journal entries for each transaction. A complete entry consists of: (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction. These transactions are journalized in [Illustration 3-18](#).

Illustration 3-18: Recording transactions in journal form

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
2014			
Oct. 1	Cash	10,000	
	Common Stock		10,000
	(Issued stock for cash)		
1	Cash	5,000	
	Notes Payable		5,000
	(Issued 3-month, 12% note payable for cash)		
2	Equipment	5,000	
	Cash		5,000
	(Purchased equipment for cash)		

Note the following features of the journal entries.

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- 1. The date of the transaction is entered in the Date column.
- 2. The account to be debited is entered first at the left. The account to be credited is then entered on the next line, indented under the line above. The indentation differentiates debits from credits and decreases the possibility of switching the debit and credit amounts.
- 3. The amounts for the debits are recorded in the Debit (left) column, and the amounts for the credits are recorded in the Credit (right) column.
- 4. A brief explanation of the transaction is given.

It is important to use correct and specific account titles in journalizing. Erroneous account titles lead to incorrect financial statements. Some flexibility exists initially in selecting account titles. The main criterion is that each title must appropriately describe the content of the account. For example, a company could use any of these account titles for recording the cost of delivery trucks: Equipment, Delivery Equipment, Delivery Trucks, or Trucks. Once the company chooses the specific title to use, however, it should record under that account title all subsequent transactions involving the account.



Accounting Across the Organization : Boosting Microsoft's Profits

At one time, **Microsoft's** Home and Entertainment Division lost over \$4 billion, mostly due to losses on the original Xbox videogame console. With the Xbox 360 videogame console, the division's head of finance, Bryan Lee, hoped the division would become profitable. He set strict goals for sales, revenue, and profit. "A manager seeking to spend more on a feature such as a disk drive has to find allies in the group to cut spending elsewhere, or identify new revenue to offset the increase," he explained.



© flyfloor/iStockphoto

For example, Microsoft originally designed the Xbox 360 to have 256 megabytes of memory. But the design department said that amount of memory wouldn't support the best special effects. The purchasing department said that adding more memory would cost \$30—which was 10% of the estimated selling price of \$300. The marketing department, however, "determined that adding the memory would let Microsoft reduce marketing costs and attract more game developers, boosting royalty revenue. It would also extend the life of the console, generating more sales." As a result, Microsoft doubled the memory to 512 megabytes. Today, the division enjoys great success.

Source: Robert A. Guth, "New Xbox Aim for Microsoft: Profitability," *Wall Street Journal* (May 24, 2005), p. C1.





JOURNAL ENTRIES

The following events occurred during the first month of business of Hair It Is Inc., Kate Browne's beauty salon:

- 1. Issued common stock to shareholders in exchange for \$20,000 cash.
- 2. Purchased \$4,800 of equipment on account (to be paid in 30 days).
- 3. Interviewed three people for the position of stylist.

In what form (type of record) should the company record these three activities? Prepare the entries to record the transactions.

Action Plan

- Record the transactions in a journal, which is a chronological record of the transactions.
- Make sure to provide a complete and accurate representation of the transactions' effects on the assets, liabilities, and stockholders' equity of the business.

Solution

Each transaction that is recorded is entered in the general journal. The three activities are recorded as follows.

1. Cash	20,000	
		Common Stock
		20,000
(Issued stock for cash)		
2. Equipment	4,800	
		Accounts Payable
		4,800
(Purchased equipment on account)		

3. No entry because no transaction occurred.

Related exercise material: [BE3-6](#), [BE3-9](#),  [3-3](#), [E3-6](#), [E3-8](#), and [E3-9](#).



THE LEDGER

The entire group of accounts maintained by a company is referred to collectively as the [ledger](#). The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.

Explain what a ledger is and how it helps in the recording process.

Companies may use various kinds of ledgers, but every company has a general ledger. A **general ledger** contains all the assets, liabilities, stockholders' equity, revenue, and expense accounts, as shown in **Illustration 3-19** (page 120). Whenever we use the term **ledger** in this textbook without additional specification, it will mean the general ledger.

Illustration 3-19: The general ledger

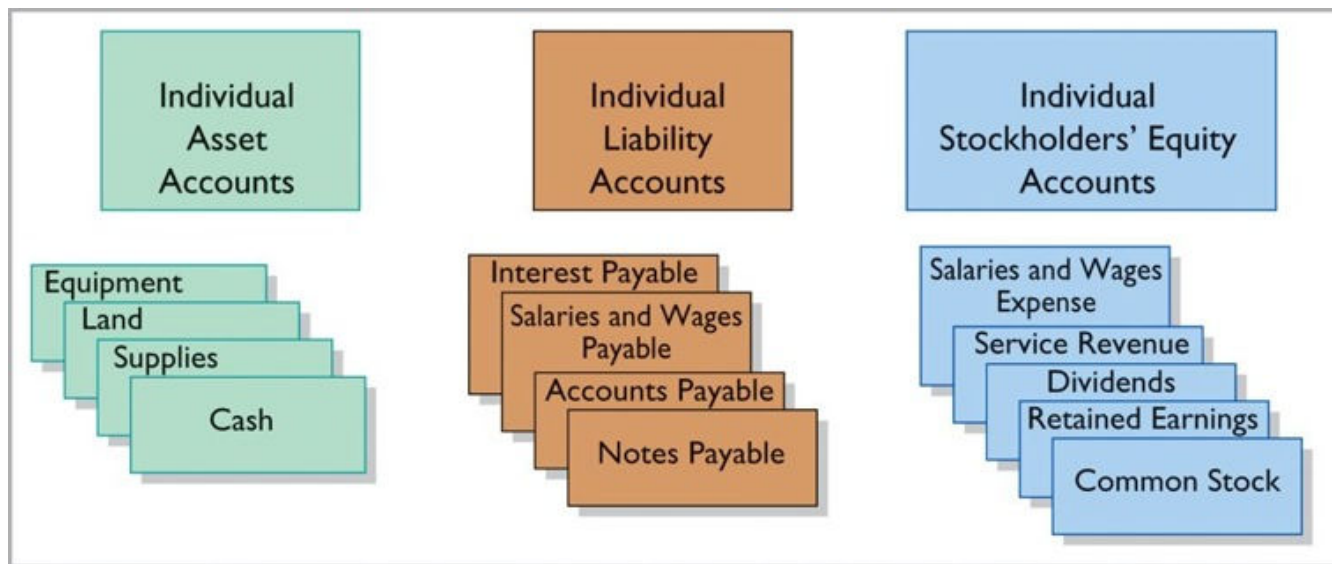


CHART OF ACCOUNTS

The number and type of accounts used differ for each company, depending on the size, complexity, and type of business. For example, the number of accounts depends on the amount of detail desired by management. The management of one company may want one single account for all types of utility expense. Another may keep separate expense accounts for each type of utility expenditure, such as gas, electricity, and water. A small corporation like Sierra Corporation will not have many accounts compared with a corporate giant like **Ford Motor Company**. Sierra may be able to manage and report its activities in 20 to 30 accounts, whereas Ford requires thousands of accounts to keep track of its worldwide activities.

Most companies list the accounts in a **chart of accounts**. They may create new accounts as needed during the life of the business. **Illustration 3-20** shows the chart of accounts for Sierra Corporation in the order that they are typically listed (assets, liabilities, stockholders' equity, revenues, and expenses). **Accounts shown in red are used in this chapter**; accounts shown in black are explained in later chapters.



Illustration 3-20: Chart of accounts for Sierra Corporation

SIERRA CORPORATION—CHART OF ACCOUNTS

Assets	Liabilities	Stockholders' Equity	Revenues	Expenses
Cash	Notes Payable	Common Stock	Service Revenue	Salaries and Wages

SIERRA CORPORATION—CHART OF ACCOUNTS

Assets	Liabilities	Stockholders' Equity	Revenues	Expenses
Accounts Receivable	Accounts Payable	Retained Earnings		Expense
Supplies	Interest Payable	Dividends		Supplies Expense
Prepaid Insurance	Unearned	Income Summary		Rent Expense
Equipment	Service Revenue			Insurance Expense
Accumulated Depreciation—	Salaries and Wages			Interest Expense
Equipment	Payable			Depreciation Expense

POSTING

The procedure of transferring journal entry amounts to ledger accounts is called **posting**. This phase of the recording process accumulates the effects of journalized transactions in the individual accounts. Posting involves these steps:

LEARNING OBJECTIVE 7

Explain what posting is and how it helps in the recording process.

- 1. In the ledger, enter in the appropriate columns of the debited account(s) the date and debit amount shown in the journal.
- 2. In the ledger, enter in the appropriate columns of the credited account(s) the date and credit amount shown in the journal.



Ethics Insight: A Convenient Overstatement

Sometimes a company's investment securities suffer a permanent decline in value below their original cost. When this occurs, the company is supposed to reduce the recorded value of the securities on its balance sheet ("write-them down" in common financial lingo) and record a loss. It appears, however, that during the financial crisis, employees at some financial institutions chose to look the other way as the value of their investments skidded. A number of Wall Street traders that worked for the investment bank **Credit Suisse Group** were charged with intentionally overstating the value of securities that had suffered declines of approximately \$2.85 billion. One reason that they may have been reluctant to record the losses is out of fear that the company's shareholders and clients would panic if they saw the magnitude of the losses. However, personal self-interest might have been equally to blame—the bonuses of the traders were tied to the value of the investment securities.



© Nuno Silva/iStockphoto

Source: S. Pulliam, J. Eaglesham, and M. Siconolfi, "U.S. Plans Changes on Bond Fraud," *Wall Street Journal Online* (February 1, 2012).



What incentives might employees have had to overstate the value of these investment securities on the company's financial statements? (See [page 159](#).)

THE RECORDING PROCESS ILLUSTRATED

[Illustrations 3-21](#) through [3-31](#) on the following pages show the basic steps in the recording process using the October transactions of Sierra Corporation. Sierra's accounting period is a month. A basic analysis and a debit–credit analysis precede the journalizing and posting of each transaction. Study these transaction analyses carefully. **The purpose of transaction analysis is first to identify the type of account involved and then to determine whether a debit or a credit to the account is required.** You should always perform this type of analysis before preparing a journal entry. Doing so will help you understand the journal entries discussed in this chapter as well as more complex journal entries to be described in later chapters.

Illustration 3-21: Investment of cash by stockholders

Event I

On October 1, stockholders invest \$10,000 cash in an outdoor guide service company to be known as Sierra Corporation.

Basic Analysis

The asset Cash is increased \$10,000; stockholders' equity (specifically Common Stock) is increased \$10,000.

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=			Common Stock
(1)	+\$10,000				+\$10,000 Issued stock

Debit-Credit Analysis

Debits increase assets: debit Cash \$10,000.
Credits increase stockholders' equity: credit Common Stock \$10,000.

Journal Entry

	Oct. 1	Cash	10,000		
		Common Stock (Issued stock for cash)			10,000

Posting

	Cash		Common Stock	
Oct. 1	10,000			Oct. 1
				10,000

Cash flow analyses show the impact of each transaction on cash.

Cash Flows
+10,000



Illustration 3-22: Issue of note payable

Event 2

On October 1, Sierra borrows cash of \$5,000 by signing a 3-month, 12%, \$5,000 note payable.

Basic Analysis

The asset Cash is increased \$5,000; the liability Notes Payable is increased \$5,000.

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=	Notes Payable		
(2)	+\$5,000		+\$5,000		

Debit-Credit Analysis

Debits increase assets: debit Cash \$5,000.
Credits increase liabilities: credit Notes Payable \$5,000.

Journal Entry

	Oct. 1	Cash	5,000	
		Notes Payable (Issued 3-month, 12% note payable for cash)		5,000

Posting

Cash			Notes Payable		
	Oct. 1	10,000		Oct. 1	5,000
	1	5,000			

Cash Flows

+5,000



Illustration 3-23: Purchase of equipment

Event 3

On October 2, Sierra used \$5,000 cash to purchase equipment.

Basic Analysis

The asset Equipment is increased \$5,000; the asset Cash is decreased \$5,000.

Equation Analysis

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash + Equipment				
(3)	-\$5,000 + \$5,000				

Debit-Credit Analysis

Debits increase assets: debit Equipment \$5,000.
Credits decrease assets: credit Cash \$5,000.

Journal Entry

	Oct. 2	Equipment Cash (Purchased equipment for cash)	5,000	5,000

Posting

Cash				Equipment			
	Oct. 1	10,000	Oct. 2	5,000		Oct. 2	5,000
		5,000					

Cash Flows

-5,000



Illustration 3-24: Receipt of cash in advance from customer

Event 4

On October 2, Sierra received a \$1,200 cash advance from R. Knox, a client, for guide services for multi-day trips that are expected to be completed in the future.

Basic Analysis

The asset Cash is increased \$1,200; the liability Unearned Service Revenue is increased \$1,200 because the service has not been performed yet. That is, when an advance payment is received, an unearned revenue (a liability) should be recorded in order to recognize the obligation that exists.

Equation Analysis

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Unearned Serv. Rev.		
(4)	+\$1,200		+\$1,200		

Debit-Credit Analysis

Debits increase assets: debit Cash \$1,200.
Credits increase liabilities: credit Unearned Service Revenue \$1,200.

Journal Entry

	Oct. 2	Cash	1,200	
		Unearned Service Revenue (Received advance from R. Knox for future service)	1,200	

Posting

Cash				Unearned Service Revenue			
	Oct. 1	10,000	Oct. 2	5,000		Oct. 2	1,200
	1	5,000					
	2	1,200					

Helpful Hint

Many liabilities have the word “payable” in their title. But, note that Unearned Service Revenue is considered a liability even though the word *payable* is not used.

Cash Flows

+1,200



Illustration 3-25: Services performed for cash

Event 5

On October 3, Sierra received \$10,000 in cash from Copa Company for guide services performed in October.

Basic Analysis

The asset Cash is increased \$10,000; the revenue Service Revenue is increased \$10,000.

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=			Revenues
(5)	+\$10,000				+\$10,000 Service Revenue

Debit-Credit Analysis

Debits increase assets: debit Cash \$10,000.
Credits increase revenues: credit Service Revenue \$10,000.

Journal Entry

	Oct. 3	Cash	10,000		
		Service Revenue (Received cash for services performed)		10,000	

Posting

Cash				Service Revenue			
Oct. 1	10,000	Oct. 2	5,000			Oct. 3	10,000
1	5,000						
2	1,200						
3	10,000						

Cash Flows

+10,000



Illustration 3-26: Payment of rent with cash

Event 6

On October 3, Sierra paid office rent for October in cash, \$900.

Basic Analysis

The expense account Rent Expense is increased \$900 because the payment pertains only to the current month; the asset Cash is decreased \$900.

Equation Analysis

$$\begin{array}{rcl}
 \text{Assets} & = & \text{Liabilities} + \text{Stockholders' Equity} \\
 \text{Cash} & = & \text{Expenses} \\
 (6) \quad -\$900 & & -\$900 \text{ Rent Expense}
 \end{array}$$

Debit-Credit Analysis

Debits increase expenses: debit Rent Expense \$900.
Credits decrease assets: credit Cash \$900.

Journal Entry

Oct. 3	Rent Expense	900	
	Cash		900
	(Paid cash for October office rent)		

Posting

Cash				Rent Expense	
Oct. 1	10,000	Oct. 2	5,000	Oct. 3	900
1	5,000	3	900		
2	1,200				
3	10,000				

Cash Flows

-900



Illustration 3-27: Purchase of insurance policy with cash

Event 7

On October 4, Sierra paid \$600 for a 1-year insurance policy that will expire next year on September 30.

Basic Analysis

The asset Cash is decreased \$600. Payments of expenses that will benefit more than one accounting period are identified as prepaid expenses or prepayments. When a payment is made, an asset account is debited in order to show the service or benefit that will be received in the future. Therefore, the asset Prepaid Insurance is increased \$600.

Equation Analysis

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	+	Prepaid Insurance		
(7)	-\$600		+\$600		

Debit-Credit Analysis

Debits increase assets: debit Prepaid Insurance \$600.
Credits decrease assets: credit Cash \$600.

Journal Entry

	Oct. 4		
	Prepaid Insurance		600
	Cash		600
	(Paid 1-year policy; effective date October 1)		

Posting

Cash				Prepaid Insurance	
Oct. 1	10,000	Oct. 2	5,000	Oct. 4	600
1	5,000	3	900		
2	1,200	4	600		
3	10,000				

Cash Flows

-600



Illustration 3-28: Purchase of supplies on account

Event 8

On October 5, Sierra purchased an estimated 3 months of supplies on account from Aero Supply for \$2,500.

Basic Analysis

The asset Supplies is increased \$2,500; the liability Accounts Payable is increased \$2,500.

Equation Analysis

$$\begin{array}{rcl}
 \text{Assets} & = & \text{Liabilities} + \text{Stockholders' Equity} \\
 \hline
 \text{Supplies} & = & \text{Accounts Payable} \\
 (8) \quad +\$2,500 & & +\$2,500
 \end{array}$$

Debit–Credit Analysis

Debits increase assets: debit Supplies \$2,500.
Credits increase liabilities: credit Accounts Payable \$2,500.

Journal Entry

Oct. 5	Supplies		2,500	
	Accounts Payable			2,500
	(Purchased supplies on account from Aero Supply)			

Posting

Supplies			Accounts Payable		
Oct. 5	2,500			Oct. 5	2,500

Cash Flows

no effect

Illustration 3-29: Hiring of new employees

Event 9

On October 9, Sierra hired four employees to begin work on October 15. Each employee will receive a weekly salary of \$500 for a 5-day work week, payable every 2 weeks—first payment made on October 26.

Basic Analysis

An accounting transaction has not occurred. There is only an agreement that the employees will begin work on October 15. Thus, a debit–credit analysis is not needed because there is no accounting entry. (See transaction of October 26 (Event II) for first payment.)

Illustration 3-30: Payment of dividend

Event II

On October 26, Sierra paid employee salaries of \$4,000 in cash.
(See October 9 event.)

Basic Analysis

The expense account Salaries and Wages Expense is increased \$4,000; the asset Cash is decreased \$4,000.

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=			Expenses
(11)	-\$4,000				-\$4,000 Salaries and Wages Expense

Debit-Credit Analysis

Debits increase expenses: debit Salaries and Wages Expense \$4,000. Credits decrease assets: credit Cash \$4,000.

Journal Entry

	Oct. 26	Salaries and Wages Expense Cash (Paid salaries to date)	4,000	4,000
			4,000	4,000

Posting

Cash				Salaries and Wages Expense	
Oct. 1	10,000	Oct. 2	5,000	Oct. 26	4,000
1	5,000	3	900		
2	1,200	4	600		
3	10,000	20	500		
		26	4,000		

Cash Flows

-4,000



SUMMARY ILLUSTRATION OF JOURNALIZING AND POSTING

The journal for Sierra Corporation for the month of October is summarized in [Illustration 3-32](#). The ledger is shown in [Illustration 3-33](#) (on [page 128](#)) with all balances highlighted in red.

Illustration 3-32: General journal for Sierra Corporation

GENERAL JOURNAL

Date Account Titles and Explanation Debit Credit

Oct. 1	Cash	10,000	
	Common Stock		10,000
	(Issued stock for cash)		
1	Cash	5,000	
	Notes Payable		5,000
	(Issued 3-month, 12% note payable for cash)		
2	Equipment	5,000	
	Cash		5,000
	(Purchased equipment for cash)		
2	Cash	1,200	
	Unearned Service Revenue		1,200
	(Received advance from R. Knox for future service)		
3	Cash	10,000	
	Service Revenue		10,000
	(Received cash for services performed)		
3	Rent Expense	900	
	Cash		900
	(Paid cash for October office rent)		
4	Prepaid Insurance	600	
	Cash		600

5	Supplies	2,500
	Accounts Payable	2,500
	(Purchased supplies on account from Aero Supply)	
20	Dividends	500
	Cash	500
	(Declared and paid a cash dividend)	
26	Salaries and Wages Expense	4,000
	Cash	4,000
	(Paid salaries to date)	

Illustration 3-33: General ledger for Sierra Corporation

GENERAL LEDGER						
Cash			Unearned Service Revenue			
Oct. 1	10,000	Oct. 2	5,000		Oct. 2	1,200
1	5,000	3	900		Bal.	1,200
2	1,200	4	600			
3	10,000	20	500			
		26	4,000			
Bal.	15,200					
Supplies			Common Stock			
Oct. 5	2,500				Oct. 1	10,000
Bal.	2,500				Bal.	10,000
Prepaid Insurance			Dividends			
Oct. 4	600			Oct. 20	500	
Bal.	600			Bal.	500	
Equipment			Service Revenue			
Oct. 2	5,000				Oct. 3	10,000
Bal.	5,000				Bal.	10,000
Notes Payable			Salaries and Wages Expense			
		Oct. 1	5,000	Oct. 26	4,000	
		Bal.	5,000	Bal.	4,000	
Accounts Payable			Rent Expense			
		Oct. 5	2,500	Oct. 3	900	
		Bal.	2,500	Bal.	900	

Do it! POSTING

Selected transactions from the journal of Faisal Inc. during its first month of operations are presented below. Post these transactions to T-accounts.

Date	Account Titles	Debit	Credit
July 1	Cash	30,000	
	Common Stock		30,000
9	Accounts Receivable	6,000	

Date	Account Titles	Debit	Credit
	Service Revenue		6,000
24	Cash	4,000	
	Accounts Receivable		4,000

Action Plan

- Journalize transactions to keep track of financial activities (receipts, payments, receivables, payables, etc.).
- To make entries useful, classify and summarize them by posting the entries to specific ledger accounts.

Solution

Cash				Accounts Receivable			
July 1	30,000			July 9	6,000	July 24	4,000
24	4,000						
Common Stock				Service Revenue			
		July 1	30,000			July 9	6,000

Related exercise material: [BE3-10](#), **Do it!** [3-4](#), and [E3-11](#).



The Trial Balance

A **trial balance** lists accounts and their balances at a given time. A company usually prepares a trial balance at the end of an accounting period. The accounts are listed in the order in which they appear in the ledger. Debit balances are listed in the left column and credit balances in the right column. The totals of the two columns must be equal.

LEARNING OBJECTIVE 8

Explain the purposes of a trial balance.

The trial balance proves the mathematical equality of debits and credits after posting. Under the double-entry system, this equality occurs when the sum of the debit account balances equals the sum of the credit account balances. **A trial balance may also uncover errors in journalizing and posting.** For example, a trial balance may well have detected the error at **MF Global** discussed in the Feature Story. **In addition, a trial balance is useful in the preparation of financial statements.**

These are the procedures for preparing a trial balance:

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- 1. List the account titles and their balances.
- 2. Total the debit column and total the credit column.
- 3. Verify the equality of the two columns.

[Illustration 3-34](#) presents the trial balance prepared from the ledger of Sierra Corporation. Note that the total debits, \$28,700, equal the total credits, \$28,700.



Illustration 3-34: Sierra Corporation trial balance

SIERRA CORPORATION

Trial Balance

October 31, 2014

	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		\$ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Common Stock		10,000
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	<u>900</u>	

Helpful Hint

Note that the order of presentation in the trial balance is:

- Assets
- Liabilities
- Stockholders' equity
- Revenues
- Expenses

LIMITATIONS OF A TRIAL BALANCE

A trial balance does not prove that all transactions have been recorded or that the ledger is correct. Numerous errors may exist even though the trial balance column totals agree. For example, the trial balance may balance even when any of the following occurs: (1) a transaction is not journalized, (2) a correct journal entry is not posted, (3) a journal entry is posted twice, (4) incorrect accounts are used in journalizing or posting, or (5) offsetting errors are made in recording the amount of a transaction. In other words, as long as equal debits and credits are posted, even to the wrong account or in the wrong amount, the total debits will equal the total credits. Nevertheless, despite these limitations, the trial balance is a useful screen for finding errors and is frequently used in practice.

Ethics Note

An **error** is the result of an unintentional mistake. It is neither ethical nor unethical. An **irregularity** is an intentional misstatement, which is viewed as unethical.



TOOLKIT

DECISION

DECISION CHECKPOINTS

INFO NEEDED FOR DECISION

TOOL TO USE FOR DECISION

HOW TO EVALUATE RESULTS

How do you determine that debits equal credits?

All account balances Trial balance

List the account titles and their balances; total the debit and credit columns; verify equality.

KEEPING AN EYE ON CASH

The Cash account shown below reflects all of the inflows and outflows of cash that occurred during October for Sierra Corporation (see [Illustrations 3-21](#) to [3-31](#)). We have also provided a description of each transaction that affected the Cash account.

LEARNING OBJECTIVE 9

Classify cash activities as operating, investing, or financing.

- 1. Oct. 1 Issued stock for \$10,000 cash.
- 2. Oct. 1 Issued note payable for \$5,000 cash.
- 3. Oct. 2 Purchased equipment for \$5,000 cash.
- 4. Oct. 2 Received \$1,200 cash in advance from customer.
- 5. Oct. 3 Received \$10,000 cash for services performed.
- 6. Oct. 3 Paid \$900 cash for October rent.
- 7. Oct. 4 Paid \$600 cash for one-year insurance policy.
- 8. Oct. 20 Paid \$500 cash dividend to stockholders.
- 9. Oct. 26 Paid \$4,000 cash salaries.

The Cash account and the related cash transactions indicate why cash changed during October. However, to make this information useful for analysis, it is summarized in a statement of cash flows. The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. A user of this statement can then determine the amount of net cash provided by operating activities, the amount of cash used for investing purposes, and the amount of cash provided by financing activities.

Cash

Oct. 1 10,000 Oct. 2 5,000

1 5,000 3 900

2 1,200 4 600

3 10,000 20 500

26 4,000

Bal. **15,200**

Operating activities are the types of activities the company performs to generate profits. Sierra Corporation is an outdoor guide business, so its operating activities involve providing guide services. Activities 4, 5, 6, 7, and 9 relate to cash received or spent to directly support its guide services.

Investing activities include the purchase or sale of long-lived assets used in operating the business, or the purchase or sale of investment securities (stocks and bonds of companies other than Sierra). Activity 3, the purchase of equipment, is an investment activity.

The primary types of **financing activities** are borrowing money, issuing shares of stock, and paying dividends. The financing activities of Sierra Corporation are Activities 1, 2, and 8.



DECISION TOOLKIT

USING THE

The **Kansas Farmers' Vertically Integrated Cooperative, Inc. (K-VIC)** was formed by over 200 northeast Kansas farmers in the late 1980s. Its purpose is to use raw materials, primarily grain and meat products grown by K-VIC's members, to process this material into end-user food products, and to distribute the products nationally. Profits not needed for expansion or investment are returned to the members annually, on a pro rata basis, according to the fair value of the grain and meat products received from each farmer.

Assume that the following trial balance was prepared for K-VIC.

KANSAS FARMERS' VERTICALLY INTEGRATED COOPERATIVE, INC.

Trial Balance

December 31, 2014

(in thousands)

	Debit	Credit
Accounts Receivable	\$ 712,000	

KANSAS FARMERS' VERTICALLY INTEGRATED COOPERATIVE, INC.

Trial Balance

December 31, 2014

(in thousands)

Accounts Payable		\$ 673,000
Buildings	365,000	
Cash	32,000	
Cost of Goods Sold	2,384,000	
Notes Payable (due in 2015)		12,000
Inventory	1,291,000	
Land	110,000	
Mortgage Payable		873,000
Equipment	63,000	
Retained Earnings		822,000
Sales Revenue		3,741,000
Salaries and Wages Payable		62,000
Salaries and Wages Expense	651,000	
Maintenance and Repairs Expense	500,000	
	\$6,108,000	\$6,183,000

Because the trial balance is not in balance, you have checked with various people responsible for entering accounting data and have discovered the following.

- 1. The purchase of 35 new trucks, costing \$7 million and paid for with cash, was not recorded.

- 3. December cash sales revenue of \$75 million was credited to the Sales Revenue account, but the other half of the entry was not made.
- 4. \$50 million of salaries expense were mistakenly charged to Maintenance and Repairs Expense.

Instructions

Answer these questions.

- (a) Which mistake(s) have caused the trial balance to be out of balance?
- (b) Should all of the items be corrected? Explain.
- (c) What is the name of the account the data entry clerk deleted?
- (d) Make the necessary corrections and prepare a correct trial balance with accounts listed in proper order.
- (e) On your trial balance, write BAL beside the accounts that go on the balance sheet and INC beside those that go on the income statement.

Solution

- (a) Only mistake #3 has caused the trial balance to be out of balance.
- (b) All of the items should be corrected. The misclassification error (mistake #4) on the salaries expense would not affect bottom-line net income, but it does affect the amounts reported in the two expense accounts.
- (c) There is no Common Stock account, so that must be the account that was deleted by the data entry clerk.
- (d) and (e):

KANSAS FARMERS' VERTICALLY INTEGRATED COOPERATIVE, INC.

Trial Balance

December 31, 2014

(in thousands)

	Debit	Credit
	_____	_____
Cash (\$32,000 – \$7,000 + \$75,000)	\$ 100,000	BAL
Accounts Receivable	712,000	BAL
Inventory	1,291,000	BAL
Land	110,000	BAL
Buildings	365,000	BAL
Equipment (\$63,000 + \$7,000)	70,000	BAL
Accounts Payable		\$ 673,000 BAL
Salaries and Wages Payable		62,000 BAL

KANSAS FARMERS' VERTICALLY INTEGRATED COOPERATIVE, INC.

Trial Balance

December 31, 2014

(in thousands)

	Debit	Credit	
Notes Payable (due in 2015)		12,000	BAL
Mortgage Payable (\$873,000 – \$472,000)		401,000	BAL
Common Stock		472,000	BAL
Retained Earnings		822,000	BAL
Sales Revenue		3,741,000	INC
Cost of Goods Sold	2,384,000		INC
Salaries and Wages Expense	701,000		INC
(\$651,000 + \$50,000)			
Maintenance and Repairs Expense	450,000		INC
(\$500,000 – \$50,000)			
	\$6,183,000	\$6,183,000	



Summary of Learning Objectives

- **1 Analyze the effect of business transactions on the basic accounting equation.** Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset is increased, there must be a corresponding (a) decrease in another asset, or (b) increase in a specific liability, or (c) increase in stockholders' equity.

- **3 Define debits and credits and explain how they are used to record business transactions.** The terms debit and credit are synonymous with left and right. Assets, dividends, and expenses are increased by debits and decreased by credits. Liabilities, common stock, retained earnings, and revenues are increased by credits and decreased by debits.
- **4 Identify the basic steps in the recording process.** The basic steps in the recording process are (a) analyze each transaction in terms of its effect on the accounts, (b) enter the transaction information in a journal, and (c) transfer the journal information to the appropriate accounts in the ledger.
- **5 Explain what a journal is and how it helps in the recording process.** The initial accounting record of a transaction is entered in a journal before the data are entered in the accounts. A journal (a) discloses in one place the complete effect of a transaction, (b) provides a chronological record of transactions, and (c) prevents or locates errors because the debit and credit amounts for each entry can be readily compared.
- **6 Explain what a ledger is and how it helps in the recording process.** The entire group of accounts maintained by a company is referred to collectively as a ledger. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.
- **7 Explain what posting is and how it helps in the recording process.** Posting is the procedure of transferring journal entries to the ledger accounts. This phase of the recording process accumulates the effects of journalized transactions in the individual accounts.
- **8 Explain the purposes of a trial balance.** A trial balance is a list of accounts and their balances at a given time. The primary purpose of the trial balance is to prove the mathematical equality of debits and credits after posting. A trial balance also uncovers errors in journalizing and posting and is useful in preparing financial statements.
- **9 Classify cash activities as operating, investing, or financing.** Operating activities are the types of activities the company performs to generate profits. Investing activities relate to the purchase or sale of long-lived assets used in operating the business, or to the purchase or sale of investment securities (stock and bonds of other companies). Financing activities are borrowing money, issuing shares of stock, and paying dividends.



DECISION

TOOLKIT *A SUMMARY*

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Has an accounting transaction occurred?	Details of the event	Accounting equation	If the event affected assets, liabilities, or stockholders' equity, then record as a transaction.

DECISION
CHECKPOINTS

INFO NEEDED
FOR DECISION

TOOL TO USE
FOR DECISION

HOW TO EVALUATE RESULTS

How do you determine that debits equal credits?

All account balances Trial balance

List the account titles and their balances; total the debit and credit columns; verify equality.

Glossary

Account

(p. [111](#)) An individual accounting record of increases and decreases in specific asset, liability, stockholders' equity, revenue or expense items.

Accounting information system

(p. [102](#)) The system of collecting and processing transaction data and communicating financial information to decision-makers.

Accounting transactions

(p. [102](#)) Events that require recording in the financial statements because they affect assets, liabilities, or stockholders' equity.

Chart of accounts

(p. [120](#)) A list of a company's accounts.

Credit

(p. [111](#)) The right side of an account.

Debit

(p. [111](#)) The left side of an account.

Double-entry system

(p. [112](#)) A system that records the two-sided effect of each transaction in appropriate accounts.

General journal

(p. [117](#)) The most basic form of journal.

General ledger

(p. [119](#)) A ledger that contains all asset, liability, stockholders' equity, revenue, and expense accounts.

Journal

(p. [117](#)) An accounting record in which transactions are initially recorded in chronological order.

Journalizing

(p. [117](#)) The procedure of entering transaction data in the journal.

Ledger

Posting

(p. 119) The group of accounts maintained by a company.
(p. 120) The procedure of transferring journal entry amounts to the ledger accounts.

T-account

(p. 111) The basic form of an account.

Trial balance

(p. 129) A list of accounts and their balances at a given time.

Comprehensive

Bob Sample and other student investors opened Campus Carpet Cleaning, Inc. on September 1, 2014. During the first month of operations, the following transactions occurred.

- Sept.
1 Stockholders invested \$20,000 cash in the business.
- 2 Paid \$1,000 cash for store rent for the month of September.
- 3 Purchased industrial carpet-cleaning equipment for \$25,000, paying \$10,000 in cash and signing a \$15,000 6-month, 12% note payable.
- 4 Paid \$1,200 for 1-year accident insurance policy.
- 10 Received bill from the *Daily News* for advertising the opening of the cleaning service, \$200.
- 15 Performed services on account for \$6,200.
- 20 Paid a \$700 cash dividend to stockholders.
- 30 Received \$5,000 from customers billed on September 15.

The chart of accounts for the company is the same as for Sierra Corporation except for the following additional account: Advertising Expense.

Instructions

- (a) Journalize the September transactions.
- (b) Open ledger accounts and post the September transactions.
- (c) Prepare a trial balance at September 30, 2014.

Action Plan

- Proceed through the accounting cycle in the following sequence:
 - 1. Make separate journal entries for each transaction.
 - 2. Note that all debits precede all credit entries.

3. In journalizing, make sure debits equal credits.
4. In journalizing, use specific account titles taken from the chart of accounts.
5. Provide an appropriate explanation of each journal entry.
6. Arrange ledger in statement order, beginning with the balance sheet accounts.
7. Post in chronological order.
8. Prepare a trial balance, which lists accounts in the order in which they appear in the ledger.
9. List debit balances in the left column and credit balances in the right column.

Solution to Comprehensive



(a) GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
2014			
Sept. 1	Cash	20,000	
	Common Stock (Issued stock for cash)		20,000
2	Rent Expense	1,000	
	Cash (Paid September rent)		1,000
3	Equipment	25,000	
	Cash		10,000
	Notes Payable (Purchased cleaning equipment for cash and 6-month, 12% note payable)		15,000
4	Prepaid Insurance	1,200	
	Cash (Paid 1-year insurance policy)		1,200
10	Advertising Expense	200	
	Accounts Payable (Received bill from <i>Daily News</i> for advertising)		200
15	Accounts Receivable	6,200	
	Service Revenue (Services performed on account)		6,200
20	Dividends	700	
	Cash (Declared and paid a cash dividend)		700
30	Cash	5,000	
	Accounts Receivable (Collection of accounts receivable)		5,000

(b) GENERAL LEDGER			
Cash		Common Stock	
Sept. 1 20,000	Sept. 2 1,000		Sept. 1 20,000
30 5,000	3 10,000		Bal. 20,000
	4 1,200		
	20 700		
Bal. 12,100			
Accounts Receivable		Dividends	
Sept. 15 6,200	Sept. 30 5,000	Sept. 20 700	
Bal. 1,200		Bal. 700	
Prepaid Insurance		Service Revenue	
Sept. 4 1,200			Sept. 15 6,200
Bal. 1,200			Bal. 6,200
Equipment		Advertising Expense	
Sept. 3 25,000		Sept. 10 200	
Bal. 25,000		Bal. 200	
Notes Payable		Rent Expense	
	Sept. 3 15,000	Sept. 2 1,000	
	Bal. 15,000	Bal. 1,000	
Accounts Payable			
	Sept. 10 200		
	Bal. 200		

(c) CAMPUS CARPET CLEANING, INC.		
Trial Balance September 30, 2014		
	Debit	Credit
Cash	\$12,100	
Accounts Receivable	1,200	
Prepaid Insurance	1,200	
Equipment	25,000	
Notes Payable		\$15,000
Accounts Payable		200
Common Stock		20,000
Dividends	700	
Service Revenue		6,200
Advertising Expense	200	
Rent Expense	1,000	
	<u>\$41,400</u>	<u>\$41,400</u>



WileyPLUS



- Self-Test, Brief Exercises, Exercises, Problem Set A, and many more resources are available for practice in WileyPLUS.

Self-Test Questions

Answers are on [page 159](#).

1.

The effects on the basic accounting equation of performing services for cash are to:

(LO 1)

- (a) increase assets and decrease stockholders' equity.
- (b) increase assets and increase stockholders' equity.
- (c) increase assets and increase liabilities.
- (d) increase liabilities and increase stockholders' equity.

2.

Genesis Company buys a \$900 machine on credit. This transaction will affect the:

(LO 1)

- (a) income statement only.
- (b) balance sheet only.
- (c) income statement and retained earnings statement only.
- (d) income statement, retained earnings statement, and balance sheet.

3.

Which of the following events is **not** recorded in the accounting records?

(LO 1)

- (a) Equipment is purchased on account.
- (b) An employee is terminated.
- (c) A cash investment is made into the business.
- (d) Company pays dividend to stockholders.

4.

During 2014, Gibson Company assets decreased \$50,000 and its liabilities decreased \$90,000. Its stockholders' equity therefore:

(LO 1)

- (a) increased \$40,000.
- (b) decreased \$140,000.
- (c) decreased \$40,000.
- (d) increased \$140,000.

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Which statement about an account is true?

(LO 2)

- (a) In its simplest form, an account consists of two parts.
- (b) An account is an individual accounting record of increases and decreases in specific asset, liability, and stockholders' equity items.
- (c) There are separate accounts for specific assets and liabilities but only one account for stockholders' equity items.
- (d) The left side of an account is the credit or decrease side.

6.

Debits:

(LO 3)

- (a) increase both assets and liabilities.
- (b) decrease both assets and liabilities.
- (c) increase assets and decrease liabilities.
- (d) decrease assets and increase liabilities.

7.

A revenue account:

(LO 3)

- (a) is increased by debits.
- (b) is decreased by credits.
- (c) has a normal balance of a debit.
- (d) is increased by credits.

8.

Which accounts normally have debit balances?

(LO 3)

- (a) Assets, expenses, and revenues.
- (b) Assets, expenses, and retained earnings.
- (c) Assets, liabilities, and dividends.
- (d) Assets, dividends, and expenses.

9.

Paying an account payable with cash affects the components of the accounting equation in the following way:

(LO 3)

- (a) Decreases stockholders' equity and decreases liabilities.
- (b) Increases assets and decreases liabilities.
- (c) Decreases assets and increases stockholders' equity.
- (d) Decreases assets and decreases liabilities.

10.

Which is **not** part of the recording process?

(LO 4)

- (a) Analyzing transactions.
- (b) Preparing a trial balance.

11.

Which of these statements about a journal is **false**?

(LO 5)

- (a) It contains only revenue and expense accounts.
- (b) It provides a chronological record of transactions.
- (c) It helps to locate errors because the debit and credit amounts for each entry can be readily compared.
- (d) It discloses in one place the complete effect of a transaction.

12.

A ledger:

(LO 6)

- (a) contains only asset and liability accounts.
- (b) should show accounts in alphabetical order.
- (c) is a collection of the entire group of accounts maintained by a company.
- (d) provides a chronological record of transactions.

13.

Posting:

(LO 7)

- (a) normally occurs before journalizing.
- (b) transfers ledger transaction data to the journal.
- (c) is an optional step in the recording process.
- (d) transfers journal entries to ledger accounts.


14.

 A trial balance:

(LO 8)

- (a) is a list of accounts with their balances at a given time.
- (b) proves that proper account titles were used.
- (c) will not balance if a correct journal entry is posted twice.
- (d) proves that all transactions have been recorded.

15.

 A trial balance will **not** balance if:

(LO 8)

- (a) a correct journal entry is posted twice.
- (b) the purchase of supplies on account is debited to Supplies and credited to Cash.
- (c) a \$100 cash dividend is debited to Dividends for \$1,000 and credited to Cash for \$100.
- (d) a \$450 payment on account is debited to Accounts Payable for \$45 and credited to Cash for \$45.

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



Questions

1.

Describe the accounting information system.

2.

Can a business enter into a transaction that affects only the left side of the basic accounting equation? If so, give an example.

3.



Are the following events recorded in the accounting records? Explain your answer in each case.

- (a) A major stockholder of the company dies.
- (b) Supplies are purchased on account.
- (c) An employee is fired.
- (d) The company pays a cash dividend to its stockholders.

4.

Indicate how each business transaction affects the basic accounting equation.

- (a) Paid cash for janitorial services.
- (b) Purchased equipment for cash.
- (c) Issued common stock to investors in exchange for cash.
- (d) Paid an account payable in full.

5.

Why is an account referred to as a T-account?

6.

The terms debit and credit mean “increase” and “decrease,” respectively. Do you agree? Explain.

7.

Terry Rabas, a fellow student, contends that the double-entry system means each transaction must be recorded twice. Is Terry correct? Explain.

8.

Misty Reno, a beginning accounting student, believes debit balances are favorable and credit balances are unfavorable. Is Misty correct? Discuss.

9.

State the rules of debit and credit as applied to (a) asset accounts, (b) liability accounts, and (c) the Common Stock account.

10.

What is the normal balance for each of these accounts?

- (a) Accounts Receivable.
- (b) Cash.

- (c) Dividends.
- (d) Accounts Payable.
- (e) Service Revenue.
- (f) Salaries and Wages Expense.
- (g) Common Stock.

11.

Indicate whether each account is an asset, a liability, or a stockholders' equity account, and whether it would have a normal debit or credit balance.

- (a) Accounts Receivable.
- (b) Accounts Payable.
- (c) Equipment.
- (d) Dividends.
- (e) Supplies.

12.

For the following transactions, indicate the account debited and the account credited.

- (a) Supplies are purchased on account.
- (b) Cash is received on signing a note payable.
- (c) Employees are paid salaries in cash.

13.

For each account listed here, indicate whether it generally will have debit entries only, credit entries only, or both debit and credit entries.

- (a) Cash.
- (b) Accounts Receivable.
- (c) Dividends.
- (d) Accounts Payable.
- (e) Salaries and Wages Expense.
- (f) Service Revenue.

14.



What are the normal balances for the following accounts of **Tootsie Roll Industries**? (a) Accounts Receivable, (b) Income Taxes Payable, (c) Sales, and (d) Selling, Marketing, and Administrative Expenses.

15.

What are the basic steps in the recording process?

16.

- (a) When entering a transaction in the journal, should the debit or credit be written first?
- (b) Which should be indented, the debit or the credit?

17.

- (a) Should accounting transaction debits and credits be recorded directly in the ledger accounts?
- (b) What are the advantages of first recording transactions in the journal and then posting to the ledger?

18.

Journalize these accounting transactions.

- (a) Stockholders invested \$12,000 in the business in exchange for common stock.
- (b) Insurance of \$800 is paid for the year.
- (c) Supplies of \$1,800 are purchased on account.

19.

- (a) What is a ledger?
- (b) Why is a chart of accounts important?

20.

What is a trial balance and what are its purposes?


21.

Tyler Bazil is confused about how accounting information flows through the accounting system. He believes information flows in this order:

- (a) Debits and credits are posted to the ledger.
- (b) Accounting transaction occurs.
- (c) Information is entered in the journal.
- (d) Financial statements are prepared.
- (e) Trial balance is prepared.

Indicate to Tyler the proper flow of the information.

22.

 Two students are discussing the use of a trial balance. They wonder whether the following errors, each considered separately, would prevent the trial balance from balancing. What would you tell them?

- (a) The bookkeeper debited Cash for \$600 and credited Salaries and Wages Expense for \$600 for payment of wages.
- (b) Cash collected on account was debited to Cash for \$800, and Service Revenue was credited for \$80.

Brief Exercises

BE3-1

Presented below are three economic events. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and stockholders' equity. In each column, indicate whether the event increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and stockholders' equity.

Determine effect of transactions on basic accounting equation.

(LO 1), C



- (a) Purchased supplies on account.
- (b) Received cash for providing a service.
- (c) Expenses paid in cash.

BE3-2

During 2014, Damon Corp. entered into the following transactions.

Determine effect of transactions on basic accounting equation.

(LO 1), AP

- 1. Borrowed \$60,000 by issuing bonds.
- 2. Paid \$9,000 cash dividend to stockholders.
- 3. Received \$13,000 cash from a previously billed customer for services performed.
- 4. Purchased supplies on account for \$3,100.

Using the following tabular analysis, show the effect of each transaction on the accounting equation. Put explanations for changes to Stockholders' Equity in the right-hand margin. For Retained Earnings, use separate columns for Revenues, Expenses, and Dividends if necessary. Use [Illustration 3-3 \(page 110\)](#) as a model.

Assets	=	Liabilities	+	Stockholders' Equity
<u>Cash</u> + <u>Accounts Receivable</u> + <u>Supplies</u>		<u>Accounts Payable</u> + <u>Bonds Payable</u>		<u>Common Stock</u> + <u>Retained Earnings</u>

BE3-3

During 2014, Comstock Company entered into the following transactions. Using the following tabular analysis, show the effect of each transaction on the accounting equation. Put explanations for changes to Stockholders' Equity in the right-hand margin. For Retained Earnings, use separate columns for Revenues, Expenses, and Dividends if necessary. Use [Illustration 3-3 \(page 110\)](#) as a model.

Determine effect of transactions on basic accounting equation.

(LO 1), AP

- 1. Purchased equipment for \$286,176 cash.
- 2. Issued common stock to investors for \$137,590 cash.
- 3. Purchased inventory of \$68,480 on account.

Using the following tabular analysis, show the effect of each transaction on the accounting equation. Put explanations for changes to Stockholders' Equity in the right-hand margin. For Retained Earnings, use separate columns for Revenues, Expenses, and Dividends if necessary. Use [Illustration 3-3 \(page 110\)](#) as a model.

Assets	=	Liabilities	+	Stockholders' Equity
<u>Cash</u> + <u>Inventory</u> + <u>Equipment</u>		<u>Accounts Payable</u>		<u>Common Stock</u> + <u>Retained Earnings</u>

BE3-4

For each of the following accounts, indicate the effect of a debit or a credit on the account and the normal balance.

Indicate debit and credit effects.

(LO 3), K

- (a) Accounts Payable.
- (b) Advertising Expense.
- (c) Service Revenue.
- (d) Accounts Receivable.
- (e) Retained Earnings.
- (f) Dividends.

BE3-5

Transactions for Grover Company for the month of June are presented below. Identify the accounts to be debited and credited for each transaction.

Identify accounts to be debited and credited.

(LO 3), C

June 1 Issues common stock to investors in exchange for \$5,000 cash.

3 Pays \$740 to landlord for June rent.

12 Bills Matt Wilfer \$700 for welding work done.

BE3-6

Use the data in [BE3-5](#) and journalize the transactions. (You may omit explanations.)

Journalize transactions.

(LO 5), AP

BE3-7

Rachelle Mohling, a fellow student, is unclear about the basic steps in the recording process. Identify and briefly explain the steps in the order in which they occur.

Identify steps in the recording process.

(LO 4), C

BE3-8

Upton Corporation has the following transactions during August of the current year. Indicate (a) the basic analysis and (b) the debit–credit analysis illustrated on [pages 121–126](#).

Indicate basic debit–credit analysis.

(LO 4), C

Aug. 1 Issues shares of common stock to investors in exchange for \$10,000.

4 Pays insurance in advance for 3 months, \$1,500.

16 Receives \$900 from clients for services rendered.

27 Pays the secretary \$620 salary.

BE3-9

Use the data in [BE3-8](#) and journalize the transactions. (You may omit explanations.)

Journalize transactions.

(LO 5), AP

BE3-10

Selected transactions for Perez Company are presented below in journal form (without explanations). Post the transactions to T-accounts.

Post journal entries to T-accounts.

(LO 7), AP

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	Date	Account Title	Debit	Credit
May	5	Accounts Receivable	3,800	
		Service Revenue		3,800
12		Cash	1,600	
		Accounts Receivable		1,600
15		Cash	2,000	
		Service Revenue		2,000

BE3-11

From the ledger balances below, prepare a trial balance for Yeager Company at June 30, 2014. All account balances are normal.

Prepare a trial balance.

(LO 8), AP

Accounts Payable	\$ 1,000
Cash	5,400
Common Stock	18,000
Dividends	1,200
Equipment	13,000
Service Revenue	\$ 8,600
Accounts Receivable	3,000
Salaries and Wages Expense	4,000
Rent Expense	1,000

BE3-12

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Prepare a corrected trial balance.

(LO 8), AP



CINELLI COMPANY

Trial Balance

December 31, 2014

	<u>Debit</u>	<u>Credit</u>
Cash	\$20,800	
Prepaid Insurance		\$ 3,500
Accounts Payable		2,500
Unearned Service Revenue	1,800	
Common Stock		10,000
Retained Earnings		6,600
Dividends		5,000
Service Revenue		25,600
Salaries and Wages Expense	14,600	
Rent Expense		2,600
	\$37,200	\$55,800

Do it! Review

Do it! 3-1

Prepare tabular analysis.

(LO 1), C

- 1. The company performed \$20,000 of services for customers on account.
- 2. The company received \$20,000 in cash from customers who had been billed for services [in transaction (1)].
- 3. The company received a bill for \$1,800 of advertising but will not pay it until a later date.
- 4. Huddleston Co. paid a cash dividend of \$3,000.

Do it! 3-2

Joel Blocker has just rented space in a strip mall. In this space, he will open a photography studio, to be called Picture This! A friend has advised Joel to set up a double-entry set of accounting records in which to record all of his business transactions.

Identify normal balances.

(LO 2, 3), C

Identify the balance sheet accounts that Joel will likely need to record the transactions needed to open his business (a corporation). Indicate whether the normal balance of each account is a debit or credit.

Do it! 3-3

Joel Blocker engaged in the following activities in establishing his photography studio, Picture This!:

Record business activities.

(LO 4, 5), AP

- 1. Opened a bank account in the name of Picture This! and deposited \$8,000 of his own money into this account in exchange for common stock.
- 2. Purchased photography supplies at a total cost of \$950. The business paid \$400 in cash, and the balance is on account.
- 3. Obtained estimates on the cost of photography equipment from three different manufacturers.

In what form (type of record) should Joel record these three activities? Prepare the entries to record the transactions.

Do it! 3-4

Joel Blocker recorded the following transactions during the month of April.

Post transactions.

(LO 6, 7), AP

Apr.	3	Cash	3,400	
		Service Revenue		3,400
	16	Rent Expense	500	
		Cash		500

Cash

300

Post these entries to the Cash account of the general ledger to determine the ending balance in cash. The beginning balance in cash on April 1 was \$1,900.

Exercises

E3-1

Selected transactions for Warner Advertising Company, Inc., are listed here.

Analyze the effect of transactions.

(LO 1), C

- 1. Issued common stock to investors in exchange for cash received from investors.
- 2. Paid monthly rent.
- 3. Received cash from customers when service was performed.
- 4. Billed customers for services performed.
- 5. Paid dividend to stockholders.
- 6. Incurred advertising expense on account.
- 7. Received cash from customers billed in (4).
- 8. Purchased additional equipment for cash.
- 9. Purchased equipment on account.

Instructions

Describe the effect of each transaction on assets, liabilities, and stockholders' equity. For example, the first answer is (1) Increase in assets and increase in stockholders' equity.

E3-2

Manning Company entered into these transactions during May 2014, its first month of operations.

Analyze the effect of transactions on assets, liabilities, and stockholders' equity.

(LO 1), AP

- 1. Stockholders invested \$40,000 in the business in exchange for common stock of the company.
- 2. Purchased computers for office use for \$30,000 from Dell on account.
- 3. Paid \$4,000 cash for May rent on storage space.
- 4. Performed computer services worth \$19,000 on account.
- 5. Performed computer services to Lawton Construction Company for \$5,000 cash.
- 6. Paid Southern States Power Co. \$8,000 cash for energy usage in May.
- 7. Paid Dell for the computers purchased in (2).
- 8. Incurred advertising expense for May of \$1,300 on account.
- 9. Received \$12,000 cash from customers for contracts billed in (4).

Instructions

Using the following tabular analysis, show the effect of each transaction on the accounting equation. Put explanations for changes to Stockholders' Equity in the right-hand margin. Use [Illustration 3-3 \(page 110\)](#) as a model.

Assets

= Liabilities +

Stockholders' Equity

$$\begin{array}{ccccccc}
 \text{Cash} & + & \text{Account} & & \text{Accounts} & + & \text{Common} & + & \text{Retained Earnings} \\
 & & \text{Receivable} & + & \text{Payable} & & \text{Stock} & & \hline
 & & & & & & & & \text{Revenues} & - & \text{Expenses} & - & \text{Dividends}
 \end{array}$$

E3-3

During 2014, its first year of operations as a delivery service, Persinger Corp. entered into the following transactions.

Determine effect of transactions on basic accounting equation.

(LO 1), AP

- 1. Issued shares of common stock to investors in exchange for \$100,000 in cash.
- 2. Borrowed \$45,000 by issuing bonds.
- 3. Purchased delivery trucks for \$60,000 cash.
- 4. Received \$16,000 from customers for services performed.
- 5. Purchased supplies for \$4,700 on account.
- 6. Paid rent of \$5,200.
- 7. Performed services on account for \$10,000.
- 8. Paid salaries of \$28,000.
- 9. Paid a dividend of \$11,000 to shareholders.

Instructions

Using the following tabular analysis, show the effect of each transaction on the accounting equation. Put explanations for changes to Stockholders' Equity in the right-hand margin. Use [Illustration 3-3 \(page 110\)](#) as a model.

Assets				=	Liabilities			+	Stockholders' Equity						
<u>Cash</u>	+	Account <u>Receivable</u>	+ <u>Supplies</u> + <u>Equipment</u>	=	Accounts <u>Payable</u>	+	Bonds <u>Payable</u>	+	Common <u>Stock</u>	+	Retained Earnings				
											<u>Revenues</u>	-	<u>Expenses</u>	-	<u>Dividends</u>

E3-4

A tabular analysis of the transactions made during August 2014 by Colaw Company during its first month of operations is shown below. Each increase and decrease in stockholders' equity is explained.

Analyze transactions and compute net income.

(LO 1), AP

<u>Transaction</u>	<u>Basic Account Type</u>	<u>Specific Account</u>	<u>Effect</u>	<u>Normal Balance</u>	<u>Account Credited Basic Type</u>	<u>Specific Account</u>	<u>Effect</u>	<u>Normal Balance</u>
	(a)	(b)	(c)	(d)	(a)	(b)	(c)	(d)
1	Asset	Cash	Increase	Debit	Stockholders' equity	Common Stock	Increase	Credit

- (b) Journalize the transactions. Do not provide explanations.

E3-7

This information relates to Crofoot Real Estate Agency.

<u>Transaction</u>	<u>Basic Type</u>	<u>Specific Account</u>	<u>Effect</u>	<u>Normal Balance</u>	<u>Basic Type</u>	<u>Specific Account</u>	<u>Effect</u>	<u>Normal Balance</u>
--------------------	-------------------	-------------------------	---------------	-----------------------	-------------------	-------------------------	---------------	-----------------------

Analyze transactions and determine their effect on accounts.

(LO 3), C

- Oct. 1 Stockholders invest \$30,000 in exchange for common stock of the corporation.
- 2 Hires an administrative assistant at an annual salary of \$36,000.
- 3 Buys office furniture for \$3,800, on account.
- 6 Sells a house and lot for M.E. Graves; commissions due from Graves, \$10,800 (not paid by Graves at this time).
- 10 Receives cash of \$140 as commission for acting as rental agent renting an apartment.
- 27 Pays \$700 on account for the office furniture purchased on October 3.
- 30 Pays the administrative assistant \$3,000 in salary for October.

Instructions

Prepare the debit–credit analysis for each transaction, as illustrated on [pages 121–126](#).

E3-8

Transaction data for Crofoot Real Estate Agency are presented in [E3-7](#).

Journalize transactions.

(LO 5), AP

Instructions

Journalize the transactions. Do not provide explanations.

E3-9

The May transactions of Hanschu Corporation were as follows.

- May 4 Paid \$700 due for supplies previously purchased on account.
- 7 Performed advisory services on account for \$6,800.
- 8 Purchased supplies for \$850 on account.
- 9 Purchased equipment for \$1,000 in cash.
- 17 Paid employees \$530 in cash.
- 22 Received bill for equipment repairs of \$900.
- 29 Paid \$1,200 for 12 months of insurance policy. Coverage begins June 1.

Instructions

Journalize the transactions. Do not provide explanations.

E3-10

Transaction data and journal entries for Crofoot Real Estate Agency are presented in [E3-7](#) and [E3-8](#).

Post journal entries and prepare a trial balance.

(LO 7, 8), AP

Instructions

- (a) Post the transactions to T-accounts.
- (b) Prepare a trial balance at October 31, 2014.

E3-11

Selected transactions for Protheroe Corporation during its first month in business are presented below.

- Sept. 1 Issued common stock in exchange for \$20,000 cash received from investors.
- 5 Purchased equipment for \$9,000, paying \$3,000 in cash and the balance on account.
- 8 Performed services on account for \$18,000.
- 14 Paid salaries of \$1,200.
- 25 Paid \$4,000 cash on balance owed for equipment.

Analyze transactions, prepare journal entries, and post transactions to T-accounts.

(LO 1, 5, 7), AP

Protheroe's chart of accounts shows Cash, Accounts Receivable, Equipment, Accounts Payable, Common Stock, Dividends, Service Revenue, and Salaries and Wages Expense.

Instructions

- (a) Prepare a tabular analysis of the September transactions. The column headings should be Cash + Accounts Receivable + Equipment = Accounts Payable + Stockholders' Equity. For transactions affecting stockholders' equity, provide explanations in the right margin, as shown on [page 110](#).
- (b) Journalize the transactions. Do not provide explanations.
- (c) Post the transactions to T-accounts.

E3-12

The T-accounts below summarize the ledger of Wheeling Gardening Company, Inc. at the end of the first month of operations.

Journalize transactions from T-accounts and prepare a trial balance.

(LO 5, 8), AP

Cash				Unearned Service Revenue			
Apr. 1	15,000	Apr. 15	800		Apr. 30	900	
	12	700	25	3,500			
	29	800					
	30	900					
Accounts Receivable				Common Stock			
Apr. 7	3,400	Apr. 29	800		Apr. 1	15,000	
Supplies				Service Revenue			
Apr. 4	5,200				Apr. 7	3,400	
						12	700
Accounts Payable				Salaries and Wages Expense			
Apr. 25	3,500	Apr. 4	5,200	Apr. 15	800		

Instructions

- (a) Prepare the journal entries (including explanations) that resulted in the amounts posted to the accounts. Present them in the order they occurred.
- (b) Prepare a trial balance at April 30, 2014.

(Hint: Compute ending balances of T-accounts first.)

E3-13

Selected transactions from the journal of Eberle Inc. during its first month of operations are presented here.

Post journal entries and prepare a trial balance.

(LO 7, 8), AP

Date	Account Titles	Debit	Credit
------	----------------	-------	--------

Date	Account Titles	Debit	Credit
Aug. 1	Cash	8,000	
	Common Stock		8,000
10	Cash	1,700	
	Service Revenue		1,700
12	Equipment	6,200	
	Cash		1,200
	Notes Payable		5,000
25	Accounts Receivable	3,400	
	Service Revenue		3,400
31	Cash	600	
	Accounts Receivable		600

Instructions

- (a) Post the transactions to T-accounts.
- (b) Prepare a trial balance at August 31, 2014.

E3-14

Here is the ledger for Keisler Co.

Journalize transactions from T-accounts and prepare a trial balance.

(LO 5, 8), AP

Cash				Common Stock			
Oct. 1	7,000	Oct. 4	400			Oct. 1	7,000
10	980	12	1,500			25	2,000
10	8,000	15	250				
20	700	30	300				
25	2,000	31	500				
Accounts Receivable				Dividends			
Oct. 6	800	Oct. 20	700	Oct. 30	300		
20	920						
Supplies				Service Revenue			
Oct. 4	400	Oct. 31	180			Oct. 6	800
						10	980
						20	920
Equipment				Salaries and Wages Expense			
Oct. 3	3,000			Oct. 31	500		
Notes Payable				Supplies Expense			
		Oct. 10	8,000	Oct. 31	180		
Accounts Payable				Rent Expense			
Oct. 12	1,500	Oct. 3	3,000	Oct. 15	250		

Instructions

- (a) Reproduce the journal entries for only the transactions that **occurred on October 1, 10, and 20**, and provide explanations for each.
- (b) Prepare a trial balance at October 31, 2014.

(Hint: Compute ending balances of T-accounts first.)

E3-15

The bookkeeper for Willingham Corporation made these errors in journalizing and posting.

Analyze errors and their effects on trial balance.

(LO 8), AN



- 1. A credit posting of \$400 to Accounts Receivable was omitted.
- 2. A debit posting of \$750 for Prepaid Insurance was debited to Insurance Expense.
- 3. A collection on account of \$100 was journalized and posted as a debit to Cash \$100 and a credit to Accounts Payable \$100.
- 4. A credit posting of \$300 to Income Taxes Payable was made twice.
- 5. A cash purchase of supplies for \$250 was journalized and posted as a debit to Supplies \$25 and a credit to Cash \$25.
- 6. A debit of \$395 to Advertising Expense was posted as \$359.

Instructions

For each error, indicate (a) whether the trial balance will balance; if the trial balance will not balance, indicate (b) the amount of the difference and (c) the trial balance column that will have the larger total. Consider each error separately. Use the following form, in which error 1 is given as an example.

	(a)	(b)	(c)
<u>Error</u>	<u>In Balance</u>	<u>Difference</u>	<u>Larger Column</u>
1	No	\$400	Debit

E3-16

The accounts in the ledger of Bastin Delivery Service contain the following balances on July 31, 2014.

Prepare a trial balance and financial statements.

(LO 8), AP



Accounts Receivable	\$13,400
Accounts Payable	8,400
Cash	?
Equipment	59,360
Maintenance and Repairs Expense	1,958
Insurance Expense	900
Notes Payable (due 2017)	28,450
Prepaid Insurance	\$ 2,200
Service Revenue	15,500
Dividends	700
Common Stock	40,000
Salaries and Wages Expense	7,428
Salaries and Wages Payable	820

Instructions

- (a) Prepare a trial balance with the accounts arranged as illustrated in the chapter, and fill in the missing amount for Cash.
- (b) Prepare an income statement, a retained earnings statement, and a classified balance sheet for the month of July 2014.

E3-17

The following accounts, in alphabetical order, were selected from recent financial statements of **Krispy Kreme Doughnuts, Inc.**

Identify normal account balance and corresponding financial statement.

(LO 3), K

Accounts Payable	Interest income
Accounts receivable	Inventories
Common Stock	Prepaid expenses
Depreciation expense	Property and equipment
Interest expense	Revenues

Instructions

For each account, indicate (a) whether the normal balance is a debit or a credit, and (b) the financial statement—balance sheet or income statement—where the account should be presented.

E3-18

Review the transactions listed in **E3-1** for Warner Advertising Company and classify each transaction as either an operating activity, investing activity, or financing activity, or if no cash is exchanged, as a noncash event.

Classify transactions as cash-flow activities.

(LO 9), AP

E3-19

Review the transactions listed in **E3-3** for Persinger Corp. and classify each transaction as either an operating activity, investing activity, or financing activity, or if no cash is exchanged, as a noncash event.

Classify transactions as cash-flow activities.

(LO 9), AP

Exercises: Set B and Challenge Exercises

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

Problems: Set A

Analyze transactions and compute net income.

(LO 1), AP



- 1. Stockholders invested \$30,000 cash in the company in exchange for common stock.
- 2. Paid \$900 cash for April office rent.
- 3. Purchased office equipment for \$3,400 cash.
- 4. Purchased \$200 of advertising in the *Chicago Tribune*, on account.
- 5. Paid \$500 cash for office supplies.
- 6. Performed services worth \$12,000. Cash of \$3,000 is received from customers, and the balance of \$9,000 is billed to customers on account.
- 7. Paid \$400 cash dividends.
- 8. Paid *Chicago Tribune* amount due in transaction (4).
- 9. Paid employees' salaries \$1,800.
- 10. Received \$9,000 in cash from customers billed previously in transaction (6).

Instructions

- (a) Prepare a tabular analysis of the transactions using these column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Common Stock, and Retained Earnings (with separate columns for Revenues, Expenses, and Dividends). Include margin explanations for any changes in Retained Earnings.

(a) Cash **\$34,800**

Total assets **\$38,700**

- (b) From an analysis of the Retained Earnings columns, compute the net income or net loss for April.

P3-2A

Nina Finzelberg started her own consulting firm, Finzelberg Consulting Inc., on May 1, 2014. The following transactions occurred during the month of May.

Analyze transactions and prepare financial statements.

(LO 1), AP



- May 1 Stockholders invested \$15,000 cash in the business in exchange for common stock.
- 2 Paid \$600 for office rent for the month.
- 3 Purchased \$500 of supplies on account.
- 5 Paid \$150 to advertise in the *County News*.

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- 9 Received \$1,400 cash for services performed.
- 12 Paid \$200 cash dividend.
- 15 Performed \$4,200 of services on account.
- 17 Paid \$2,500 for employee salaries.
- 20 Paid for the supplies purchased on account on May 3.
- 23 Received a cash payment of \$1,200 for services performed on account on May 15.
- 26 Borrowed \$5,000 from the bank on a note payable.
- 29 Purchased office equipment for \$2,000 paying \$200 in cash and the balance on account.
- 30 Paid \$180 for utilities.

Instructions

- (a) Show the effects of the previous transactions on the accounting equation using the following format. Assume the note payable is to be repaid within the year. Include margin explanations for any changes in Retained Earnings.

(a) Cash **\$18,270**

Total assets **\$23,770**

Assets	= Liabilities	+ Stockholders' Equity
<u>Date</u> <u>Cash</u> + <u>Accounts Receivable</u> + <u>Supplies</u> + <u>Equipment</u>	= <u>Notes Payable</u> + <u>Accounts Payable</u> + <u>Common Stock</u>	+ <u>Retained Earnings</u> <u>Revenues</u> – <u>Expenses</u> – <u>Dividends</u>

- (b) Prepare an income statement for the month of May 2014.

(b) Net income **\$2,170**

- (c) Prepare a classified balance sheet at May 31, 2014.

P3-3A

Cindy Braun created a corporation providing legal services, Cindy Braun Inc., on July 1, 2014. On July 31 the balance sheet showed Cash \$4,000; Accounts Receivable \$2,500; Supplies \$500; Equipment \$5,000; Accounts Payable \$4,200; Common Stock \$6,200; and Retained Earnings \$1,600. During August, the following transactions occurred.

Analyze transactions and prepare an income statement, retained earnings statement, and balance sheet.



- Aug. 1 Collected \$1,100 of accounts receivable due from customers.
- 4 Paid \$2,700 cash for accounts payable due.
- 9 Performed services worth \$5,400, of which \$3,600 is collected in cash and the balance is due in September.
- 15 Purchased additional office equipment for \$4,000, paying \$700 in cash and the balance on account.
- 19 Paid salaries \$1,400, rent for August \$700, and advertising expenses \$350.
- 23 Paid a cash dividend of \$700.
- 26 Borrowed \$5,000 from Standard Federal Bank; the money was borrowed on a 4-month note payable.
- 31 Incurred utility expenses for the month on account \$380.

Instructions

- (a) Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column heading should be Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Common Stock + Retained Earnings + Revenues – Expenses – Dividends. Include margin explanations for any changes in Retained Earnings.

(a) Cash **\$7,150**

- (b) Prepare an income statement for August, a retained earnings statement for August, and a classified balance sheet at August 31.

(b) Net income **\$2,570**

Ret. earnings **\$3,470**

P3-4A

Friendley's Miniature Golf and Driving Range Inc. was opened on March 1 by Dean Barley. These selected events and transactions occurred during March.

Journalize a series of transactions.

(LO 4, 5), AP



- Mar. 1 Stockholders invested \$50,000 cash in the business in exchange for common stock of the corporation.
- 3 Purchased Arnie's Golf Land for \$38,000 cash. The price consists of land \$23,000, building \$9,000, and equipment \$6,000. (Record this in a single entry.)
- 5 Advertised the opening of the driving range and miniature golf course, paying advertising expenses of \$1,200 cash.
- 6 Paid cash \$2,400 for a 1-year insurance policy.
- 10 Purchased golf clubs and other equipment for \$5,500 from Golden Bear Company, payable in 30 days.
- 18 Received golf fees of \$1,600 in cash from customers for golf services performed.
- 19 Sold 100 coupon books for \$25 each in cash. Each book contains ten coupons that enable the holder to play one round of miniature golf or to hit one bucket of golf balls. (*Hint*: The revenue should not be recognized until the customers use the coupons.)
- 25 Paid a \$500 cash dividend.
- 30 Paid salaries of \$800.
- 30 Paid Golden Bear Company in full for equipment purchased on March 10.
- 31 Received \$900 in cash from customers for golf services performed.

The company uses these accounts: Cash, Prepaid Insurance, Land, Buildings, Equipment, Accounts Payable, Unearned Service Revenue, Common Stock, Retained Earnings, Dividends, Service Revenue, Advertising Expense, and Salaries and Wages Expense.

Instructions

Journalize the March transactions, including explanations. Friendly's records golf fees as service revenue.

P3-5A

Foyle Architects incorporated as licensed architects on April 1, 2014. During the first month of the operation of the business, these events and transactions occurred:

Journalize transactions, post, and prepare a trial balance.

(LO 5, 6, 7, 8), AP



- Apr. 1 Stockholders invested \$18,000 cash in exchange for common stock of the corporation.
- 1 Hired a secretary-receptionist at a salary of \$375 per week, payable monthly.
- 2 Paid office rent for the month \$900.
- 3 Purchased architectural supplies on account from Burlington Company \$1,300.
- 10 Completed blueprints on a carport and billed client \$1,900 for services.
- 11 Received \$700 cash advance from J. Madison to design a new home.
- 20 Received \$2,800 cash for services completed and delivered to M. Svetlana.
- 30 Paid secretary-receptionist for the month \$1,500.
- 30 Paid \$300 to Burlington Company for accounts payable due.

The company uses these accounts: Cash, Accounts Receivable, Supplies, Accounts Payable, Unearned Service Revenue, Common Stock, Service Revenue, Salaries and Wages Expense, and Rent Expense.

Instructions

- (a) Journalize the transactions, including explanations.
- (b) Post to the ledger T-accounts.
- (c) Prepare a trial balance on April 30, 2014.

(c) Cash \$18,800

Tot. trial balance \$24,400

P3-6A

This is the trial balance of Solis Company on September 30.

Journalize transactions, post, and prepare a trial balance.

(LO 5, 6, 7, 8), AP



SOLIS COMPANY

Trial Balance

September 30, 2014

	<u>Debit</u>	<u>Credit</u>
Cash	\$19,200	
Accounts Receivable	2,600	
Supplies	2,100	
Equipment	8,000	
Accounts Payable		\$ 4,800
Unearned Service Revenue		1,100
Common Stock		15,000
Retained Earnings	<u> </u>	<u>11,000</u>
	\$31,900	\$31,900

The October transactions were as follows.

- Oct. 5 Received \$1,300 in cash from customers for accounts receivable due.
- 10 Billed customers for services performed \$5,100.
- 15 Paid employee salaries \$1,200.
- 17 Performed \$600 of services in exchange for cash.
- 20 Paid \$1,900 to creditors for accounts payable due.
- 29 Paid a \$300 cash dividend.

Instructions

- (a) Prepare a general ledger using T-accounts. Enter the opening balances in the ledger accounts as of October 1. Provision should be made for these additional accounts: Dividends, Service Revenue, Salaries and Wages Expense, and Utilities Expense.
- (b) Journalize the transactions, including explanations.
- (c) Post to the ledger accounts.
- (d) Prepare a trial balance on October 31, 2014.

(d) Cash \$17,300

Tot. trial balance \$35,700

P3-7A

This trial balance of Swisher Co. does not balance.

Prepare a correct trial balance.

(LO 8), AN



SWISHER CO.

Trial Balance

June 30, 2014

	Debit	Credit
Cash		\$ 3,090
Accounts Receivable	\$ 3,190	
Supplies	800	
Equipment	3,000	
Accounts Payable		3,686
Unearned Service Revenue	1,200	

SWISHER CO.

Trial Balance

June 30, 2014

	Debit	Credit
Common Stock		9,000
Dividends	800	
Service Revenue		3,480
Salaries and Wages Expense	3,600	
Utilities Expense	910	
	\$13,500	\$19,256

Each of the listed accounts has a normal balance per the general ledger. An examination of the ledger and journal reveals the following errors:

- 1. Cash received from a customer on account was debited for \$780, and Accounts Receivable was credited for the same amount. The actual collection was for \$870.
- 2. The purchase of a printer on account for \$340 was recorded as a debit to Supplies for \$340 and a credit to Accounts Payable for \$340.
- 3. Services were performed on account for a client for \$900. Accounts Receivable was debited for \$90 and Service Revenue was credited for \$900.
- 4. A debit posting to Salaries and Wages Expense of \$700 was omitted.
- 5. A payment on account for \$206 was credited to Cash for \$206 and credited to Accounts Payable for \$260.
- 6. Payment of a \$600 cash dividend to Swisher's stockholders was debited to Salaries and Wages Expense for \$600 and credited to Cash for \$600.

Instructions

Prepare the correct trial balance. (*Hint:* All accounts have normal balances.)

Tot. trial balance **\$16,900**

P3-8A

The Sequel Theater Inc. was recently formed. It began operations in March 2014. The Sequel is unique in that it will show only triple features of sequential theme movies. On March 1, the ledger of The Sequel showed Cash \$16,000; Land \$38,000; Buildings (concession stand, projection room, ticket booth, and screen) \$22,000; Equipment \$16,000; Accounts Payable \$12,000; and Common Stock \$80,000. During the month of March, the following events and transactions occurred.

Journalize transactions, post, and prepare a trial balance.



- Mar. 2 Rented the three *Star Wars* movies (*Star Wars*®, *The Empire Strikes Back*, and *The Return of the Jedi*) to be shown for the first three weeks of March. The film rental was \$10,000; \$2,000 was paid in cash and \$8,000 will be paid on March 10.
- 3 Ordered the first three *Star Trek* movies to be shown the last 10 days of March. It will cost \$500 per night.
- 9 Received \$9,900 cash from admissions.
- 10 Paid balance due on *Star Wars* movies' rental and \$2,900 on March 1 accounts payable.
- 11 The Sequel Theater contracted with J. Russo to operate the concession stand. Russo agrees to pay The Sequel 15% of gross receipts, payable monthly, for the rental of the concession stand.
- 12 Paid advertising expenses \$500.
- 20 Received \$8,300 cash from customers for admissions.
- 20 Received the *Star Trek* movies and paid rental fee of \$5,000.
- 31 Paid salaries of \$3,800.
- 31 Received statement from J. Russo showing gross receipts from concessions of \$10,000 and the balance due to The Sequel of \$1,500($\$10,000 \times .15$) for March. Russo paid half the balance due and will remit the remainder on April 5.
- 31 Received \$20,000 cash from customers for admissions.

In addition to the accounts identified above, the chart of accounts includes Accounts Receivable, Service Revenue, Rent Revenue, Advertising Expense, Rent Expense, and Salaries and Wages Expense.

Instructions

- (a) Using T-accounts, enter the beginning balances to the ledger.
- (b) Journalize the March transactions, including explanations. The Sequel records admission revenue as service revenue, concession revenue as sales revenue, and film rental expense as rent expense.
- (c) Post the March journal entries to the ledger.
- (d) Prepare a trial balance on March 31, 2014.

(d) Cash \$ 32,750

Tot. trial balance \$128,800

(LO 8), AN

- 1. A credit to Supplies of \$600 was omitted.
- 2. A debit posting of \$300 to Accounts Payable was inadvertently debited to Accounts Receivable.
- 3. A purchase of supplies on account of \$450 was debited to Supplies for \$540 and credited to Accounts Payable for \$540.
- 4. A credit posting of \$680 to Interest Payable was posted twice.
- 5. A debit posting to Income Taxes Payable for \$250 and a credit posting to Cash for \$250 were made twice.
- 6. A debit posting for \$1,200 of Dividends was inadvertently posted to Salaries and Wages Expense instead.
- 7. A credit to Service Revenue for \$450 was inadvertently posted as a debit to Service Revenue.
- 8. A credit to Accounts Receivable of \$250 was credited to Accounts Payable.

Instructions

For each error, indicate (a) whether the trial balance will balance; (b) the amount of the difference if the trial balance will not balance; and (c) the trial balance column that will have the larger total. Consider each error separately. Use the following form, in which error 1 is given as an example.

	(a)	(b)	(c)
Error	In Balance	Difference	Larger Column
1.	No	\$600	Debit

Problems: Set B

P3-1B

Hyman Inc. was started on May 1. Here is a summary of the May transactions.

Analyze transactions and compute net income.

(LO 1), AP



- 1. Stockholders invested \$30,000 cash in the company in exchange for common stock.
- 2. Purchased equipment for \$10,000 cash.
- 3. Paid \$700 cash for May office rent.
- 4. Paid \$300 cash for supplies.
- 5. Purchased \$750 of advertising in the *Evening Times* on account.
- 6. Received \$8,000 in cash from customers for service.
- 7. Paid a \$500 cash dividend.
- 8. Paid part-time employee salaries \$1,000.
- 9. Paid utility bills \$140.
- 10. Performed service on account to customers \$2,000.
- 11. Collected cash of \$1,000 for services billed in transaction (10).

Instructions

- (a) Prepare a tabular analysis of the transactions using these column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Common Stock, and Retained Earnings (with separate columns for Revenues, Expenses, and Dividends). Revenue is called Service Revenue. Include margin explanations for any changes in Retained Earnings.

Total assets \$37,660

- (b) From an analysis of the Retained Earnings columns, compute the net income or net loss for May.

P3-2B

Ned Walz started his own delivery service, Walz Service Inc., on June 1, 2014. The following transactions occurred during the month of June.

Analyze transactions and prepare financial statements.

(LO 1), AP



- June 1 Stockholders invested \$20,000 cash in the business in exchange for common stock.

- 2 Purchased a used van for deliveries for \$10,000. Walz paid \$2,000 cash and signed a note payable for the remaining balance.

- 3 Paid \$600 for office rent for the month.

- 5 Performed \$3,000 of services on account.

- 9 Paid \$300 in cash dividends.

- 12 Purchased supplies for \$240 on account.

- 15 Received a cash payment of \$1,000 for services performed on June 5.

- 17 Received a bill for \$200 to cover advertisements in *Tri-State News*.

- 20 Received a cash payment of \$1,500 for services performed.

- 23 Made a cash payment of \$1,000 on the note payable.

- 26 Paid \$180 for utilities.

- 29 Paid for the supplies purchased on account on June 12.

- 30 Paid \$750 for employee salaries.

Assets				=	Liabilities		+	Stockholders' Equity	
Date	Cash	Accounts Receivable	+ Supplies + Equipment	=	Notes Payable	+ Accounts Payable	+	Common Stock	+ Retained Earnings
									Revenues - Expenses - Dividends

(a) Cash \$17,430

Include margin explanations for any changes in Retained Earnings.

- (b) Prepare an income statement for the month of June.
- (c) Prepare a classified balance sheet at June 30, 2014.

P3-3B

Joe Thyme opened Thyme Company, a veterinary business in Neosho, Missouri, on August 1, 2014. On August 31, the balance sheet showed Cash \$9,000; Accounts Receivable \$1,700; Supplies \$600; Equipment \$5,000; Accounts Payable \$3,600; Common Stock \$10,000; and Retained Earnings \$2,700. During September, the following transactions occurred.

Analyze transactions and prepare an income statement, retained earnings statement, and balance sheet.

(LO 1), AP



- Sept. 2 Paid \$3,400 cash for accounts payable due.
- 5 Received \$1,200 from customers in payment of accounts receivable.
- 8 Purchased additional office equipment for \$5,100, paying \$1,000 in cash and the balance on account.
- 13 Performed services worth \$10,600, of which \$2,300 is paid in cash and the balance is due in October.
- 17 Paid a \$600 cash dividend.
- 22 Paid salaries \$900, rent for September \$1,100, and advertising expense \$250.
- 26 Incurred utility expenses for the month on account \$220.
- 30 Received \$5,000 from Hilldale Bank on a 6-month note payable.

Instructions

- (a) Prepare a tabular analysis of the September transactions beginning with August 31 balances. The column headings should be Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Common Stock +

(a) Cash \$10,250

- (b) Prepare an income statement for September, a retained earnings statement for September, and a classified balance sheet at September 30, 2014.

(b) Ret. earnings \$10,230

P3-4B

Beefeaters RV Park was started on April 1 by Sarah Rhodes. These selected events and transactions occurred during April.

Journalize a series of transactions.

(LO 4, 5), AP



- Apr. 1 Stockholders invested \$100,000 cash in the business in exchange for common stock.
- 4 Purchased land costing \$250,000 for cash.
- 8 Purchased advertising in local newspaper for \$1,200 on account.
- 11 Paid salaries to employees \$3,000.
- 12 Hired park manager at a salary of \$3,600 per month, effective May 1.
- 13 Paid \$7,200 for a 1-year insurance policy.
- 17 Paid \$600 cash dividends.
- 20 Received \$6,000 in cash from customers for admission fees.
- 25 Sold 100 coupon books for \$90 each. Each book contains ten coupons that entitle the holder to one admission to the park. (*Hint: The revenue should not be recognized until the coupons are used.*)
- 30 Received \$7,900 in cash from customers for admission fees.
- 30 Paid \$400 of the balance owed for the advertising purchased on account on April 8.

The company uses the following accounts: Cash, Prepaid Insurance, Land, Accounts Payable, Unearned Service Revenue, Common Stock, Dividends, Service Revenue, Advertising Expense, and Salaries and Wages Expense.

Instructions

P3-5B

Bob Royce incorporated Royce Consulting, an accounting practice, on May 1, 2014. During the first month of operations, these events and transactions occurred.

Journalize transactions, post, and prepare a trial balance.

(LO 5, 6, 7, 8), AP



- May 1 Stockholders invested \$100,000 cash in exchange for common stock of the corporation.
- 2 Hired a secretary-receptionist at a salary of \$2,500 per month.
- 3 Purchased \$800 of supplies on account from Pickering Supply Company.
- 7 Paid office rent of \$1,400 for the month.
- 11 Completed a tax assignment and billed client \$2,500 for services performed.
- 12 Received \$4,200 advance on a management consulting engagement.
- 17 Received cash of \$3,300 for services completed for Woodman Co.
- 31 Paid secretary-receptionist \$2,500 salary for the month.
- 31 Paid 50% of balance due Pickering Supply Company.

The company uses the following chart of accounts: Cash, Accounts Receivable, Supplies, Accounts Payable, Unearned Service Revenue, Common Stock, Service Revenue, Salaries and Wages Expense, and Rent Expense.

Instructions

- (a) Journalize the transactions, including explanations.
- (b) Post to the ledger T-accounts.
- (c) Prepare a trial balance on May 31, 2014.

(c) Cash	\$103,200
Tot. trial balance	\$110,400

P3-6B

The trial balance of American Dry Cleaners on June 30 is given here.



AMERICAN DRY CLEANERS

Trial Balance

June 30, 2014

	<u>Debit</u>	<u>Credit</u>
Cash	\$15,532	
Accounts Receivable	10,536	
Supplies	3,592	
Equipment	25,950	
Accounts Payable		\$15,800
Unearned Service Revenue		1,810
Common Stock		25,000
Retained Earnings		13,000
	\$55,610	\$55,610

The July transactions were as follows.

- July 8 Received \$10,189 in cash on June 30 accounts receivable.
- 9 Paid employee salaries \$2,100.
- 11 Received \$7,320 in cash for services performed.
- 14 Paid creditors \$4,810 of accounts payable.
- 17 Purchased supplies on account \$720.

- 22 Reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.
- 30 Paid employee salaries \$3,114, utilities \$1,767, and repairs \$386.
- 31 Paid \$400 cash dividend.

Instructions

- (a) Prepare a general ledger using T-accounts. Enter the opening balances in the ledger accounts as of July 1. Provision should be made for the following additional accounts: Dividends, Service Revenue, Maintenance and Repairs Expense, Salaries and Wages Expense, and Utilities Expense.
- (b) Journalize the transactions, including explanations.
- (c) Post to the ledger accounts.
- (d) Prepare a trial balance on July 31, 2014.

(d) Cash \$20,464

Tot. trial balance \$63,540

P3-7B

This trial balance of Lindbergh Company does not balance.

Prepare a correct trial balance.

(LO 8), AN

LINDBERGH COMPANY

Trial Balance

May 31, 2014

	Debit	Credit
Cash	\$ 5,340	
Accounts Receivable		\$ 2,750
Prepaid Insurance	700	
Equipment	9,000	
Accounts Payable		4,100
Income Taxes Payable	850	

LINDBERGH COMPANY

Trial Balance

May 31, 2014

	Debit	Credit
Common Stock		5,700
Retained Earnings		6,000
Service Revenue	7,690	
Salaries and Wages Expense	4,200	
Advertising Expense		1,100
Income Tax Expense	900	
	\$28,680	\$19,650

Your review of the ledger reveals that each account has a normal balance. You also discover the following errors.

- 1. The totals of the debit sides of Prepaid Insurance, Accounts Payable, and Income Tax Expense were each understated \$100.
- 2. Transposition errors were made in Accounts Receivable and Service Revenue. Based on postings made, the correct balances were \$2,570 and \$7,960, respectively.
- 3. A debit posting to Salaries and Wages Expense of \$500 was omitted.
- 4. A \$600 cash dividend was debited to Common Stock for \$600 and credited to Cash for \$600.
- 5. A \$350 purchase of supplies on account was debited to Equipment for \$350 and credited to Cash for \$350.
- 6. A cash payment of \$490 for advertising was debited to Advertising Expense for \$49 and credited to Cash for \$49.
- 7. A collection from a customer for \$240 was debited to Cash for \$240 and credited to Accounts Payable for \$240.

Instructions

Prepare the correct trial balance, assuming all accounts have normal balances. (Note: The chart of accounts also includes the following: Dividends and Supplies.)

Cash	\$ 5,249
Tot. trial balance	\$25,220

P3-8B

Roxy Theater Inc. was recently formed. All facilities were completed on March 31. On April 1, the ledger showed: Cash \$6,300; Land \$10,000; Buildings (concession stand, projection room, ticket booth, and screen) \$58,000; Equipment \$6,000; Accounts

Journalize transactions, post, and prepare a trial balance.

(LO 5, 6, 7, 8), AP



- Apr. 2 Paid film rental fee of \$1,800 on first movie.
- 3 Ordered two additional films at \$750 each.
- 9 Received \$5,700 cash from admissions.
- 10 Paid \$2,000 of mortgage payable and \$1,200 of accounts payable.
- 11 Roxy Theater contracted with M. Gavin to operate the concession stand. Gavin agrees to pay Roxy Theater 17% of gross receipts, payable monthly.
- 12 Paid advertising expenses \$410.
- 20 Received one of the films ordered on April 3 and was billed \$750. The film will be shown in April.
- 25 Received \$3,000 cash from customers for admissions.
- 29 Paid salaries \$1,900.
- 30 Received statement from M. Gavin showing gross receipts of \$2,000 and the balance due to Roxy Theater of \$340($\$2,000 \times .17$) for April. Gavin paid half of the balance due and will remit the remainder on May 5.
- 30 Prepaid \$1,200 rental fee on special film to be run in May.

In addition to the accounts identified above, the chart of accounts shows Accounts Receivable, Prepaid Rent, Service Revenue, Rent Revenue, Advertising Expense, Rent Expense, Salaries and Wages Expense.

Instructions

- (a) Enter the beginning balances in the ledger T-accounts as of April 1.
- (b) Journalize the April transactions, including explanations. (*Note:* Roxy records admission revenue as service revenue, concession revenue as sales revenue, and film rental expense as rent expense.)
- (c) Post the April journal entries to the ledger T-accounts.
- (d) Prepare a trial balance on April 30, 2014.

(d) Cash \$ 6,660

Tot. trial balance \$86,890

A first year co-op student working for Solutia Inc. recorded the transactions for the month. He wasn't exactly sure how to journalize and post, but he did the best he could. He had a few questions, however, about the following transactions.

Analyze errors and their effects on the trial balance.

(LO 8), AN

- 1. Cash received from a customer on account was recorded as a debit to Cash of \$360 and a credit to Accounts Receivable of \$630, instead of \$360.
- 2. A service performed for cash was posted as a debit to Cash of \$2,000 and a credit to Service Revenue of \$2,000.
- 3. A debit of \$880 for services performed on account was neither recorded nor posted. The credit was recorded correctly.
- 4. The debit to record \$1,000 of cash dividends was posted to the Salaries and Wages Expense account.
- 5. The purchase, on account, of a computer that cost \$2,500 was recorded as a debit to Supplies and a credit to Accounts Payable.
- 6. A cash payment of \$495 for salaries was recorded as a debit to Dividends and a credit to Cash.
- 7. Payment of month's rent was debited to Rent Expense and credited to Cash, \$850.
- 8. Issue of \$5,000 of common shares was credited to the Common Stock account, but no debit was recorded.

Instructions

- (a) Indicate which of the above transactions are correct, and which are incorrect.
- (b) For each error identified in (a), indicate (1) whether the trial balance will balance; (2) the amount of the difference if the trial balance will not balance; and (3) the trial balance column that will have the larger total. Consider each error separately. Use the following form, in which transaction 1 is given as an example.

	(1)	(2)	(3)
Error	In Balance	Difference	Larger Column
1.	No	\$270	Credit

Problems: Set C

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

Continuing Cookie Chronicle



(Note: This is a continuation of the Cookie Chronicle from [Chapters 1](#) and [2](#).)

CCC3

In November 2014, after having incorporated Cookie Creations Inc., Natalie begins operations. She has decided not to pursue the offer to supply cookies to Biscuits. Instead, she will focus on offering cooking classes. The following events occur.

- Nov. 8 Natalie cashes in her U.S. Savings Bonds and receives \$520, which she deposits in her personal bank account.
- 8 Natalie opens a bank account for Cookie Creations Inc.
- 8 Natalie purchases \$500 of Cookie Creations' common stock.
- 11 Cookie Creations purchases paper and other office supplies for \$95. (Use Supplies.)
- 14 Cookie Creations pays \$125 to purchase baking supplies, such as flour, sugar, butter, and chocolate chips. (Use Supplies.)
- 15 Natalie starts to gather some baking equipment to take with her when teaching the cookie classes. She has an excellent top-of-the-line food processor and mixer that originally cost her \$550. Natalie decides to start using it only in her new business. She estimates that the equipment is currently worth \$300, and she transfers the equipment into the business in exchange for additional common stock.
- 16 The company needs more cash to sustain its operations. Natalie's grandmother lends the company \$2,000 cash, in exchange for a two-year, 9% note payable. Interest and the principal are repayable at maturity.

- 17 Cookie Creations pays \$900 for additional baking equipment.
- 18 Natalie schedules her first class for November 29. She will receive \$100 on the date of the class.
- 25 Natalie books a second class for December 5 for \$150. She receives a \$60 cash down payment, in advance.
- 29 Natalie teaches her first class, booked on November 18, and collects the \$100 cash.

30 Natalie's brother develops a website for Cookie Creations Inc. that the company will use for advertising. He charges the company \$600 for his work, payable at the end of December. (Because the website is expected to have a useful life of two years before upgrades are needed, it should be treated as an asset called Website.)

30 Cookie Creations pays \$1,200 for a one-year insurance policy.

30 Natalie teaches a group of elementary school students how to make Santa Claus cookies. At the end of the class, Natalie leaves an invoice for \$300 with the school principal. The principal says that he will pass it along to the business office and it will be paid some time in December.

30 Natalie receives a \$50 invoice for use of her cell phone. She uses the cell phone exclusively for Cookie Creations Inc. business. The invoice is for services performed in November, and payment is due on December 15.

Instructions

- (a) Prepare journal entries to record the November transactions.
- (b) Post the journal entries to the general ledger accounts.
- (c) Prepare a trial balance at November 30, 2014.

(c) Trial balance total \$3,910

Broadening Your Perspective

Financial Reporting and Analysis

FINANCIAL REPORTING PROBLEM: *Tootsie Roll Industries Inc.*

BYP3-1

The financial statements of **Tootsie Roll** in [Appendix A](#) at the back of this textbook contain the following selected accounts, all in thousands of dollars.



Common Stock	\$ 25,040
Accounts Payable	9,791

Selling, Marketing, and Administrative Expenses	106,316
Prepaid Expenses	6,499
Net Property, Plant, and Equipment	215,492
Net Product Sales	517,149

Instructions

- (a) What is the increase and decrease side for each account? What is the normal balance for each account?
- (b) Identify the probable other account in the transaction and the effect on that account when:
 - (1) Accounts Receivable is decreased.
 - (2) Accounts Payable is decreased.
 - (3) Prepaid Expenses is increased.
- (c) Identify the other account(s) that ordinarily would be involved when:
 - (1) Interest Expense is increased.
 - (2) Property, Plant, and Equipment is increased.

COMPARATIVE ANALYSIS PROBLEM: *Tootsie Roll vs. Hershey*

BYP3-2

The financial statements of **The Hershey Company** appear in [Appendix B](#), following the financial statements for **Tootsie Roll** in [Appendix A](#).



Instructions

- (a) Based on the information contained in these financial statements, determine the normal balance for:

Tootsie Roll Industries

The Hershey Company

- | | |
|---|--|
| <ul style="list-style-type: none"> ◦ (1) Accounts Receivable ◦ (2) Net Property, Plant, and Equipment ◦ (3) Accounts Payable ◦ (4) Retained Earnings ◦ (5) Net Product Sales | <ul style="list-style-type: none"> ◦ (1) Inventories ◦ (2) Provision for Income Taxes ◦ (3) Accrued Liabilities ◦ (4) Common Stock ◦ (5) Interest Expense |
|---|--|
- (b) Identify the other account ordinarily involved when:
 - (1) Accounts Receivable is increased.
 - (2) Notes Payable is decreased.
 - (3) Machinery is increased.
 - (4) Interest Revenue is increased.

RESEARCH CASE

BYP3-3

Instructions

Read the article and answer the following questions.

- (a) Why are the Green Bay Packers the only professional football team to publish and distribute an annual report?
- (b) Why is the football players' labor union particularly interested in the Packers' annual report?
- (c) In addition to the players' labor union, what other outside party might be interested in the annual report?
- (d) Even though the Packer's revenue increased in recent years, the company's operating profit fell significantly. How does the article explain this decline?

INTERPRETING FINANCIAL STATEMENTS

BYP3-4

Chieftain International, Inc., is an oil and natural gas exploration and production company. A recent balance sheet reported \$208 million in assets with only \$4.6 million in liabilities, all of which were short-term accounts payable.

During the year, Chieftain expanded its holdings of oil and gas rights, drilled 37 new wells, and invested in expensive 3-D seismic technology. The company generated \$19 million cash from operating activities and paid no dividends. It had a cash balance of \$102 million at the end of the year.

Instructions

- (a) Name at least two advantages to Chieftain from having no long-term debt. Can you think of disadvantages?
- (b) What are some of the advantages to Chieftain from having this large a cash balance? What is a disadvantage?
- (c) Why do you suppose Chieftain has the \$4.6 million balance in accounts payable, since it appears that it could have made all its purchases for cash?

REAL-WORLD FOCUS

BYP3-5

Purpose: This activity provides information about career opportunities for CPAs.

Address: www.startheregoplaces.com/why-accounting, or go to www.wiley.com/college/kimmel

Steps

1. Go to the address shown above and click on **Students/Educators**.
2. Click on **High School**, then **CPA101** for parts (a), (b), and (c).
3. Click **College** to answer part (d).

Instructions

Answer the following questions.

- (a) Where do CPAs work?
- (b) What skills does a CPA need?
- (c) What is the salary range for a CPA at a large firm during the first three years? What is the salary range for chief financial officers and treasurers at large corporations?

Critical Thinking

DECISION-MAKING ACROSS THE ORGANIZATION

BYP3-6

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Sally Saia operates Double S Riding Academy, Inc. The academy's primary sources of revenue are riding fees and lesson fees, which are provided on a cash basis. Sally also boards horses for owners, who are billed monthly for boarding fees. In a few cases, boarders pay in advance of expected use. For its revenue transactions, the academy maintains these accounts: Cash, Accounts Receivable, Unearned Service Revenue, and Service Revenue.

The academy owns 10 horses, a stable, a riding corral, riding equipment, and office equipment. These assets are accounted for in the following accounts: Horses, Buildings, and Equipment.

The academy employs stable helpers and an office employee, who receive weekly salaries. At the end of each month, the mail usually brings bills for advertising, utilities, and veterinary service. Other expenses include feed for the horses and insurance. For its expenses, the academy maintains the following accounts: Supplies, Prepaid Insurance, Accounts Payable, Salaries and Wages Expense, Advertising Expense, Utilities Expense, Maintenance and Repairs Expense, Supplies Expense, and Insurance Expense.

Sally Saia's sole source of personal income is dividends from the academy. Thus, the corporation declares and pays periodic dividends. To account for stockholders' equity in the business and dividends, two accounts are maintained: Common Stock and Dividends.

During the first month of operations an inexperienced bookkeeper was employed. Sally Saia asks you to review the following eight entries of the 50 entries made during the month. In each case, the explanation for the entry is correct.

May 1	Cash	15,000	
	Unearned Service Revenue		15,000
	(Issued common stock in exchange for \$15,000 cash)		
5	Cash	250	
	Service Revenue		250
	(Received \$250 cash for lesson fees)		
7	Cash	500	
	Service Revenue		500
	(Received \$500 for boarding of horses beginning June 1)		
9	Supplies Expense	1,500	
	Cash		1,500
	(Purchased estimated 5 months' supply of feed and hay for \$1,500 on account)		
14	Equipment	80	
	Cash		800

15	Salaries and Wages Expense	400	
	Cash		400
	(Issued check to Sally Saia for personal use)		
20	Cash	145	
	Service Revenue		154
	(Received \$154 cash for riding fees)		
31	Maintenance and Repairs Expense	75	
	Accounts Receivable		75
	(Received bill of \$75 from carpenter for repair services performed)		

Instructions

With the class divided into groups, answer the following.

- (a) For each journal entry that is correct, so state. For each journal entry that is incorrect, prepare the entry that should have been made by the bookkeeper.
- (b) Which of the incorrect entries would prevent the trial balance from balancing?
- (c) What was the correct net income for May, assuming the bookkeeper originally reported net income of \$4,500 after posting all 50 entries?
- (d) What was the correct cash balance at May 31, assuming the bookkeeper reported a balance of \$12,475 after posting all 50 entries?

COMMUNICATION ACTIVITY

BYP3-7

Clean Sweep Company offers home cleaning service. Two recurring transactions for the company are billing customers for services performed and paying employee salaries. For example, on March 15 bills totaling \$6,000 were sent to customers, and \$2,000 was paid in salaries to employees.

Instructions

Write a memorandum to your instructor that explains and illustrates the steps in the recording process for each of the March 15 transactions. Use the format illustrated in the textbook under the heading “The Recording Process Illustrated” ([pp. 121–126](#)).

ETHICS CASES

BYP3-8

Jennifer VanPelt is the assistant chief accountant at BIT Company, a manufacturer of computer chips and cellular phones. The company presently has total sales of \$20 million. It is the end of the first quarter and Jennifer is hurriedly trying to prepare a trial

In order to meet the 4 p.m. deadline, Jennifer decides to force the debits and credits into balance by adding the amount of the difference to the Equipment account. She chose Equipment because it is one of the larger account balances; percentage-wise it will be the least misstated. Jennifer plugs the difference! She believes that the difference is quite small and will not affect anyone's decisions. She wishes that she had another few days to find the error but realizes that the financial statements are already late.

Instructions

- (a) Who are the stakeholders in this situation?
- (b) What ethical issues are involved?
- (c) What are Jennifer's alternatives?

BYP3-9

The July 28, 2007, issue of the *Wall Street Journal* includes an article by Kathryn Kranhold entitled "GE's Accounting Draws Fresh Focus on News of Improper Sales Bookings."

Instructions

Read the article and answer the following questions.

- (a) What improper activity did the employees at GE engage in?
- (b) Why might the employees have engaged in this activity?
- (c) What were the implications for the employees who engaged in this activity?
- (d) What does it mean to "restate" financial results? Why didn't GE restate its results to correct for the improperly reported locomotive sales?

ALL ABOUT YOU

BYP3-10

In their annual reports to stockholders, companies must report or disclose information about all liabilities, including potential liabilities related to environmental clean-up. There are many situations in which you will be asked to provide personal financial information about your assets, liabilities, revenue, and expenses. Sometimes you will face difficult decisions regarding what to disclose and how to disclose it.

Instructions

Suppose that you are putting together a loan application to purchase a home. Based on your income and assets, you qualify for the mortgage loan, but just barely. How would you address each of the following situations in reporting your financial position for the loan application? Provide responses for each of the following questions.

- (a) You signed a guarantee for a bank loan that a friend took out for \$20,000. If your friend doesn't pay, you will have to pay. Your friend has made all of the payments so far, and it appears he will be able to pay in the future.
- (b) You were involved in an auto accident in which you were at fault. There is the possibility that you may have to pay as much as \$50,000 as part of a settlement. The issue will not be resolved before the bank processes your mortgage request.
- (c) The company at which you work isn't doing very well, and it has recently laid off employees. You are still employed, but it is quite possible that you will lose your job in the next few months.

Answers to Insight and Accounting Across the Organization Questions

p. 109 Why Accuracy Matters Q: In order for these companies to prepare and issue financial statements, their accounting equations (debit and credits) must have been in balance at year-end. How could these errors or misstatements have occurred? **A:** A company's accounting equation (its books) can be in balance yet its financial statements have errors or misstatements because of the following: entire transactions were not recorded; transactions were recorded at wrong amounts; transactions were recorded in the wrong accounts; transactions were recorded in the wrong accounting period. Audits of financial statements uncover some, but obviously not all, errors or misstatements.

p. 115 Keeping Score Q: Do you think that the Chicago Bears football team would be likely to have the same major revenue and expense accounts as the Cubs? **A:** Because their businesses are similar—professional sports—many of the revenue and expense accounts for the baseball and football teams might be similar.

p. 119 Boosting Microsoft's Profits Q: In what ways is this Microsoft division using accounting to assist in its effort to become more profitable? **A:** The division has used accounting to set very strict sales, revenue, and profit goals. In addition, the managers in this division use accounting to keep a tight rein on product costs. Also, accounting serves as the basis of communication so that the marketing managers and product designers can work with production managers, engineers, and accountants to create an exciting product within specified cost constraints.

p. 121 A Convenient Overstatement Q: What incentives might employees have had to overstate the value of these investment securities on the company's financial statements? **A:** One reason that they may have been reluctant to record the losses is out of fear that the company's shareholders and clients would panic if they saw the magnitude of the losses. However, personal self-interest might have been equally to blame—the bonuses of the traders were tied to the value of the investment securities.

Answers to Self-Test Questions

1. b 2. b 3. b 4. a ($-\$50,000 = -\$90,000 + \$40,000$) 5. b 6. c 7. d 8. d 9. d 10. b 11. a 12. c 13. d 14. a 15. c



A Look at IFRS

International companies use the same set of procedures and records to keep track of transaction data. Thus, the material in Chapter 3 dealing with the account, general rules of debit and credit, and steps in the recording process—the journal, ledger, and chart of accounts—is the same under both GAAP and IFRS.

LEARNING OBJECTIVE 10

Compare the procedures for the recording process under GAAP and IFRS.

KEY POINTS

- Transaction analysis is the same under IFRS and GAAP but, as you will see in later chapters, different standards sometimes impact how transactions are recorded.
- Rules for accounting for specific events sometimes differ across countries. For example, European companies rely less on historical cost and more on fair value than U.S. companies. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.
- Both the IASB and FASB go beyond the basic definitions provided in this textbook for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses. The more substantive definitions, using the IASB

- A trial balance under IFRS follows the same format as shown in the textbook.
- As shown in the textbook, dollar signs are typically used only in the trial balance and the financial statements. The same practice is followed under IFRS, using the currency of the country in which the reporting company is headquartered.
- The SEC has expressed a desire to continue working toward a single set of high-quality standards. In deciding whether the United States should adopt IFRS, some of the issues the SEC stated should be considered are:
 - Whether IFRS is sufficiently developed and consistent in application.
 - Whether the IASB is sufficiently independent.
 - Whether IFRS is established for the benefit of investors.
 - The issues involved in educating investors about IFRS.
 - The impact of a switch to IFRS on U.S. laws and regulations.
 - The impact on companies including changes to their accounting systems, contractual arrangements, corporate governance, and litigation.
 - The issues involved in educating accountants, so they can prepare statements under IFRS.

LOOKING TO THE FUTURE

The basic recording process shown in this textbook is followed by companies across the globe. It is unlikely to change in the future. The definitional structure of assets, liabilities, equity, revenues, and expenses may change over time as the IASB and FASB evaluate their overall conceptual framework for establishing accounting standards.

IFRS PRACTICE

IFRS SELF-TEST QUESTIONS

1.

Which statement is **correct** regarding IFRS?

- (a) IFRS reverses the rules of debits and credits; that is, debits are on the right and credits are on the left.
- (b) IFRS uses the same process for recording transactions as GAAP.
- (c) The chart of accounts under IFRS is different because revenues follow assets.
- (d) None of the above statements are correct.

2.

The expanded accounting equation under IFRS is as follows:

- (a) $\text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Dividends} + \text{Revenues} - \text{Expenses}$.
- (b) $\text{Assets} + \text{Liabilities} = \text{Share Capital} + \text{Dividends} + \text{Revenues} - \text{Expenses}$.
- (c) $\text{Assets} = \text{Liabilities} + \text{Share Capital} - \text{Dividends} + \text{Revenues} - \text{Expenses}$.
- (d) $\text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Dividends} - \text{Revenues} - \text{Expenses}$.

3.

A trial balance:

- (a) is the same under IFRS and GAAP.
- (b) proves that transactions are recorded correctly.
- (c) proves that all transactions have been recorded.
- (d) will not balance if a correct journal entry is posted twice.

4.

One difference between IFRS and GAAP is that:

- (a) GAAP uses accrual-accounting concepts and IFRS uses primarily the cash basis of accounting.
- (b) IFRS uses a different posting process than GAAP.
- (c) IFRS uses more fair value measurements than GAAP.
- (d) the limitations of a trial balance are different between IFRS and GAAP.

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reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.

The general policy for using proper currency signs (dollar, yen, pound, etc.) is the same for both IFRS and this textbook. This policy is as follows:

- (a) Currency signs only appear in ledgers and journal entries.
- (b) Currency signs are only shown in the trial balance.
- (c) Currency signs are shown for all compound journal entries.
- (d) Currency signs are shown in trial balances and financial statements.

IFRS CONCEPTS AND APPLICATION

IFRS3-1

Describe some of the issues the SEC must consider in deciding whether the United States should adopt IFRS.