

### A Look Back



Chapter 1 defined accounting and introduced financial statements. We described forms of organizations and identified users and uses of accounting. We defined the accounting equation and applied it to transaction analysis.

### A Look at This Chapter



This chapter focuses on the accounting process. We describe transactions and source documents, and we explain the analysis and recording of transactions. The accounting equation, T-account, general ledger, trial balance, and debits and credits are key tools in the accounting process.

### A Look Ahead



Chapter 3 extends our focus on processing information. We explain the importance of adjusting accounts and the procedures in preparing financial statements.

# 2 Analyzing and Recording Transactions

## Learning Objectives

### CAP

#### CONCEPTUAL

- C1** Explain the steps in processing transactions and the role of source documents. (p. 52)
- C2** Describe an account and its use in recording transactions. (p. 53)
- C3** Describe a ledger and a chart of accounts. (p. 56)
- C4** Define *debits* and *credits* and explain double-entry accounting. (p. 57)

#### ANALYTICAL

- A1** Analyze the impact of transactions on accounts and financial statements. (p. 61)
- A2** Compute the debt ratio and describe its use in analyzing financial condition. (p. 72)



LP2

#### PROCEDURAL

- P1** Record transactions in a journal and post entries to a ledger. (p. 58)
- P2** Prepare and explain the use of a trial balance. (p. 67)
- P3** Prepare financial statements from business transactions. (p. 68)



## Decision Insight



## Sole Sisters

*"Every way we can cut costs, we do!"*

—SUSIE LEVITT (on right)

NEW YORK—"High heels were killing our feet, but we didn't want to give them up because we aren't the tallest people out there," insists Susie Levitt, who stands no taller than 5'2". "So we came up with the idea of emergency footwear." Susie, along with Katie Shea, designed a stylish, foldable slip-on ballet flat with a pouch that is readily tucked into a handbag and pulled out when their feet cry for mercy. The empty pouch then expands into a tote bag to hold their "killer" heels for carrying home. Launched from their college apartment, Susie and Katie invested "less than \$10,000" for the cost of their first order of 1,000 pairs, including Website design, to launch **CitySlips** ([www.cityslips.com](http://www.cityslips.com)).

To pursue their business ambitions, Susie and Katie took business courses, including accounting. They learned and applied recordkeeping processes, transaction analysis, inventory accounting, and financial statement reporting. "We were careful to get a handle on our financial situation," says Katie. Today, the two are running a profitable business and have a reliable accounting system to help them make good business decisions.

"We had to account for product costs, design expenses, supplier payments, patent fees, and other expenses," says Susie. At the same time, the two have grown sales and expanded their product line. "It was all done online," says Susie. "We became nocturnal!"

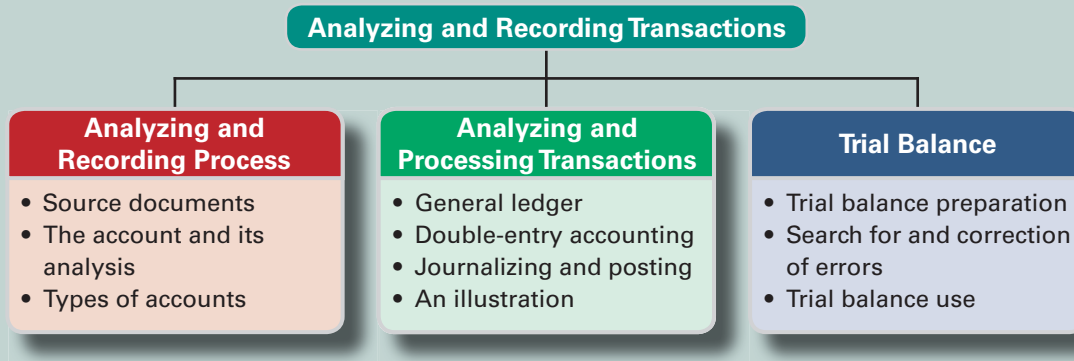
The two insist that it is crucial to track and account for all revenues and expenses, and what is invested in the business. They maintain that success requires proper accounting for and analysis of the financial side. Susie also suggests that young entrepreneurs "network with your professors and other staff members. They have years of experience and can often help you, or introduce you to people who can help you, with your business."

"The bigger message of our company," says Susie, "is promoting comfort and confidence for women." Adds Katie, "Regardless of what your business is, the story of starting while in college differentiates you from the beginning!"

[Sources: *CitySlips Website*, January 2012; *Entrepreneur*, December 2009; *Examiner.com*, December 2009; *CNN.com*, August 2009; *Daily News*, May 2009; *Teen Business Forum*, March 11, 2011, Video]

Financial statements report on the financial performance and condition of an organization. Knowledge of their preparation, organization, and analysis is important. A main goal of this chapter is to illustrate how transactions are recorded, how

they are reflected in financial statements, and how they impact analysis of financial statements. Debits and credits are introduced and identified as a tool in helping analyze and process transactions.

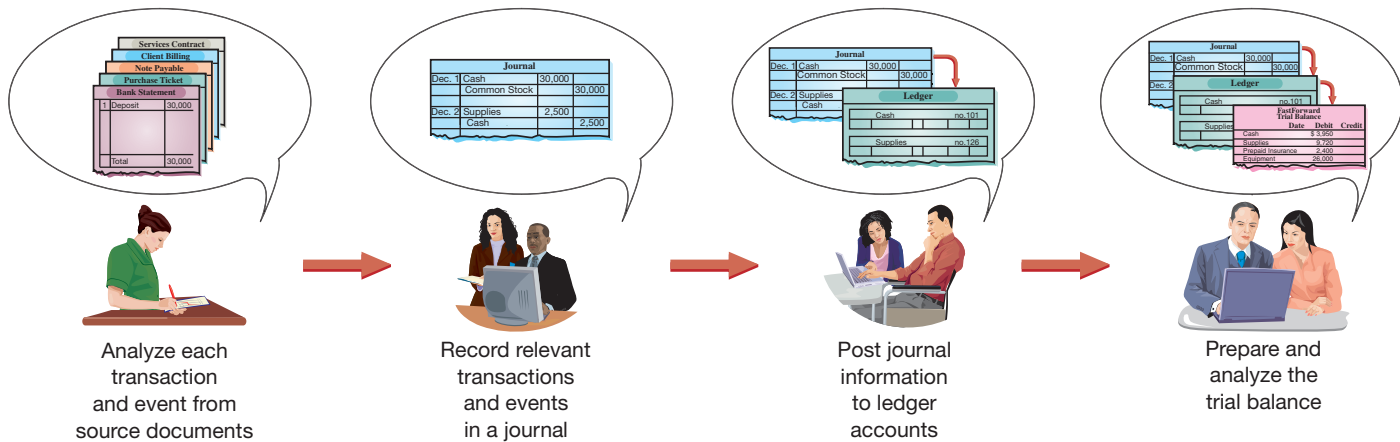


## ANALYZING AND RECORDING PROCESS

The accounting process identifies business transactions and events, analyzes and records their effects, and summarizes and presents information in reports and financial statements. These reports and statements are used for making investing, lending, and other business decisions. The steps in the accounting process that focus on *analyzing and recording* transactions and events are shown in Exhibit 2.1.

### EXHIBIT 2.1

The Analyzing and Recording Process



**C1** Explain the steps in processing transactions and the role of source documents.

Business transactions and events are the starting points. Relying on source documents, the transactions and events are analyzed using the accounting equation to understand how they affect company performance and financial position. These effects are recorded in accounting records, informally referred to as the *accounting books*, or simply the *books*. Additional steps such as posting and then preparing a trial balance help summarize and classify the effects of transactions and events. Ultimately, the accounting process provides information in useful reports or financial statements to decision makers.

### Source Documents

**Source documents** identify and describe transactions and events entering the accounting process. They are the sources of accounting information and can be in either hard copy or electronic form. Examples are sales tickets, checks, purchase orders, bills from suppliers, employee



earnings records, and bank statements. To illustrate, when an item is purchased on credit, the seller usually prepares at least two copies of a sales invoice. One copy is given to the buyer. Another copy, often sent electronically, results in an entry in the seller's information system to record the sale. Sellers use invoices for recording sales and for control; buyers use them for recording purchases and for monitoring purchasing activity. Many cash registers record information for each sale on a tape or electronic file locked inside the register. This record can be used as a source document for recording sales in the accounting records. Source documents, especially if obtained from outside the organization, provide objective and reliable evidence about transactions and events and their amounts.

**Point:** To ensure that all sales are rung up on the register, most sellers require customers to have their receipts to exchange or return purchased items.

## Decision Ethics

Answer — p. 76

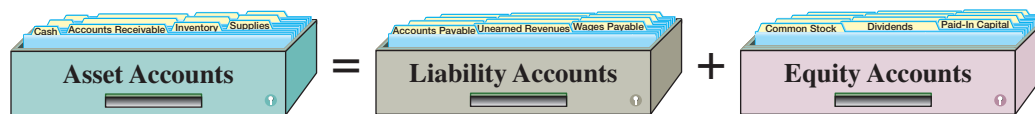


**Cashier** Your manager requires that you, as cashier, immediately enter each sale. Recently, lunch hour traffic has increased and the assistant manager asks you to avoid delays by taking customers' cash and making change without entering sales. The assistant manager says she will add up cash and enter sales after lunch. She says that, in this way, the register will always match the cash amount when the manager arrives at three o'clock. What do you do? ■

## The Account and Its Analysis

An **account** is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item. Information from an account is analyzed, summarized, and presented in reports and financial statements. The **general ledger**, or simply **ledger**, is a record containing all accounts used by a company. The ledger is often in electronic form. While most companies' ledgers contain similar accounts, a company often uses one or more unique accounts because of its type of operations. As shown in Exhibit 2.2, accounts are classified into three general categories based on the accounting equation: asset, liability, or equity.

**C2** Describe an account and its use in recording transactions.



### EXHIBIT 2.2

Accounts Organized by the Accounting Equation

**Asset Accounts** Assets are resources owned or controlled by a company, and those resources have expected future benefits. Most accounting systems include (at a minimum) separate accounts for the assets described here.

A *Cash* account reflects a company's cash balance. All increases and decreases in cash are recorded in the Cash account. It includes money and any medium of exchange that a bank accepts for deposit (coins, checks, money orders, and checking account balances).

*Accounts receivable* are held by a seller and refer to promises of payment from customers to sellers. These transactions are often called *credit sales* or *sales on account* (or *on credit*). Accounts receivable are increased by credit sales and are decreased by customer payments. A company needs a separate record for each customer, but for now, we use the simpler practice of recording all increases and decreases in receivables in a single account called Accounts Receivable.

A *note receivable*, or promissory note, is a written promise of another entity to pay a definite sum of money on a specified future date to the holder of the note. A company holding a promissory note signed by another entity has an asset that is recorded in a Note (or Notes) Receivable account.

*Prepaid accounts* (also called *prepaid expenses*) are assets that represent prepayments of future expenses (*not* current expenses). When the expenses are later incurred, the amounts in prepaid accounts are transferred to expense accounts. Common examples of prepaid accounts include prepaid insurance, prepaid rent, and prepaid services (such as club memberships). Prepaid accounts expire with the passage of time (such as with rent) or through use (such as with prepaid meal tickets). When financial statements are prepared, prepaid accounts are adjusted so that (1) all expired and used prepaid accounts are recorded as regular expenses and (2) all unexpired and unused prepaid accounts are recorded as assets (reflecting future use in

**Point:** Customers and others who owe a company are called its **debtors**.

**Point:** A college parking fee is a prepaid account from the student's standpoint. At the beginning of the term, it represents an asset that entitles a student to park on or near campus. The benefits of the parking fee expire as the term progresses. At term-end, prepaid parking (asset) equals zero as it has been entirely recorded as parking expense.



**Point:** Prepaid accounts that apply to current and future periods are assets. These assets are adjusted at the end of each period to reflect only those amounts that have not yet expired, and to record as expenses those amounts that have expired.

**Point:** Some assets are described as *intangible* because they do not have physical existence or their benefits are highly uncertain. A recent balance sheet for **Coca-Cola Company** shows nearly \$1 billion in intangible assets.

future periods). To illustrate, when an insurance fee, called a *premium*, is paid in advance, the cost is typically recorded in the asset account Prepaid Insurance. Over time, the expiring portion of the insurance cost is removed from this asset account and reported in expenses on the income statement. Any unexpired portion remains in Prepaid Insurance and is reported on the balance sheet as an asset. (An exception exists for prepaid accounts that will expire or be used before the end of the current accounting period when financial statements are prepared. In this case, the prepayments *can* be recorded immediately as expenses.)

*Supplies* are assets until they are used. When they are used up, their costs are reported as expenses. The costs of unused supplies are recorded in a Supplies asset account. Supplies are often grouped by purpose—for example, office supplies and store supplies. *Office supplies* include stationery, paper, toner, and pens. *Store supplies* include packaging materials, plastic and paper bags, gift boxes and cartons, and cleaning materials. The costs of these unused supplies can be recorded in an Office Supplies or a Store Supplies asset account. When supplies are used, their costs are transferred from the asset accounts to expense accounts.

*Equipment* is an asset. When equipment is used and gets worn down, its cost is gradually reported as an expense (called depreciation). Equipment is often grouped by its purpose—for example, office equipment and store equipment. *Office equipment* includes computers, printers, desks, chairs, and shelves. Costs incurred for these items are recorded in an Office Equipment asset account. The Store Equipment account includes the costs of assets used in a store, such as counters, showcases, ladders, hoists, and cash registers.

*Buildings* such as stores, offices, warehouses, and factories are assets because they provide expected future benefits to those who control or own them. Their costs are recorded in a Buildings asset account. When several buildings are owned, separate accounts are sometimes kept for each of them.

The cost of *land* owned by a business is recorded in a Land account. The cost of buildings located on the land is separately recorded in one or more building accounts.

### Decision Insight



**Women Entrepreneurs** The Center for Women's Business Research reports that women-owned businesses, such as **CitySlips**, are growing and that they:

- Total approximately 11 million and employ nearly 20 million workers.
- Generate \$2.5 trillion in annual sales and tend to embrace technology.
- Are philanthropic—70% of owners volunteer at least once per month.
- Are more likely funded by individual investors (73%) than venture firms (15%). ■



**Liability Accounts** Liabilities are claims (by creditors) against assets, which means they are obligations to transfer assets or provide products or services to others. **Creditors** are individuals and organizations that have rights to receive payments from a company. If a company fails to pay its obligations, the law gives creditors a right to force the sale of that company's assets to obtain the money to meet creditors' claims. When assets are sold under these conditions, creditors are paid first, but only up to the amount of their claims. Any remaining money, the residual, goes to the owners of the company. Creditors often use a balance sheet to help decide whether to loan money to a company. A loan is less risky if the borrower's liabilities are small in comparison to assets because this means there are more resources than claims on resources. Common liability accounts are described here.

*Accounts payable* refer to oral or implied promises to pay later, which usually arise from purchases of merchandise. Payables can also arise from purchases of supplies, equipment, and services. Accounting systems keep separate records about each creditor. We describe these individual records in Chapter 4.

A *note payable* refers to a formal promise, usually denoted by the signing of a promissory note, to pay a future amount. It is recorded in either a short-term Note Payable account or a long-term Note Payable account, depending on when it must be repaid. We explain details of short- and long-term classification in Chapter 3.

**Unearned revenue** refers to a liability that is settled in the future when a company delivers its products or services. When customers pay in advance for products or services (before revenue

**Point:** Accounts payable are also called *trade payables*.



is earned), the revenue recognition principle requires that the seller consider this payment as unearned revenue. Examples of unearned revenue include magazine subscriptions collected in advance by a publisher, sales of gift certificates by stores, and season ticket sales by sports teams. The seller would record these in liability accounts such as Unearned Subscriptions, Unearned Store Sales, and Unearned Ticket Revenue. When products and services are later delivered, the earned portion of the unearned revenue is transferred to revenue accounts such as Subscription Fees, Store Sales, and Ticket Sales.<sup>1</sup>

*Accrued liabilities* are amounts owed that are not yet paid. Examples are wages payable, taxes payable, and interest payable. These are often recorded in separate liability accounts by the same title. If they are not large in amount, one or more ledger accounts can be added and reported as a single amount on the balance sheet. (Financial statements often have amounts reported that are a summation of several ledger accounts.)

**Point:** If a subscription is canceled, the publisher is expected to refund the unused portion to the subscriber.

### Decision Insight

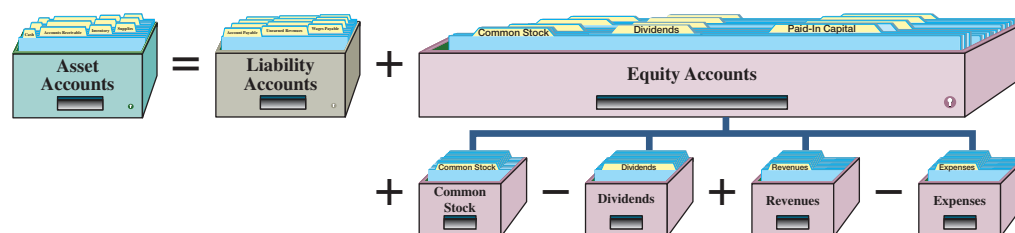


**Revenue Spread** The **New Orleans Saints** have *Unearned Revenues* of about \$60 million in advance ticket sales. When the team plays its home games, it settles this liability to its ticket holders and then transfers the amount earned to *Ticket Revenues*. ■



**Equity Accounts** The owner's claim on a company's assets is called *equity*, or *stockholders' equity*, or *shareholders' equity*. Equity is the owners' *residual interest* in the assets of a business after deducting liabilities. Equity is impacted by four types of accounts: common stock, dividends, revenues, and expenses. We show this visually in Exhibit 2.3 by expanding the accounting equation. (As Chapter 1 explains, the accounts for dividends, revenues, and expenses are reflected in the retained earnings account, and that account is reported in the balance sheet.)

**Point:** Equity is also called *net assets*.



### EXHIBIT 2.3

Expanded Accounting Equation

When an owner invests in a company in exchange for common stock, the invested amount is recorded in an account titled **Common Stock**. Any further owner investments are recorded in this account. When the company pays any cash dividends, it decreases both the company's assets and its total equity. Dividends are not expenses of the business. They are simply the opposite of owner investments. A **Dividends** account is used in recording asset distributions to stockholders (owners).

**Point:** The Dividends account is sometimes referred to as a *contra equity* account because it reduces the normal balance of equity.

Revenues and expenses also impact equity. Examples of revenue accounts are Sales, Commissions Earned, Professional Fees Earned, Rent Revenue, and Interest Revenue. *Revenues increase equity* and result from products and services provided to customers. Examples of expense accounts are Advertising Expense, Store Supplies Expense, Office Salaries Expense, Office Supplies Expense, Rent Expense, Utilities Expense, and Insurance Expense. *Expenses decrease equity* and result from assets and services used in a company's operations. The variety of revenues and expenses can be seen by looking at the *chart of accounts* that follows the index at the

**Point:** The withdrawal of assets by the owners of a corporation is called a *dividend*.

<sup>1</sup> In practice, account titles vary. As one example, Subscription Fees is sometimes called Subscription Fees Revenue, Subscription Fees Earned, or Earned Subscription Fees. As another example, Rent Earned is sometimes called Rent Revenue, Rental Revenue, or Earned Rent Revenue. We must use good judgment when reading financial statements because titles can differ even within the same industry. For example, product sales are called *revenue* at **Research In Motion**, but *net sales* at **Apple**. Generally, the term *revenues* or *fees* is more commonly used with service businesses, and *net sales* or *sales* with product businesses.



back of this book. (Different companies sometimes use different account titles than those in this book's chart of accounts. For example, some might use Interest Revenue instead of Interest Earned, or Rental Expense instead of Rent Expense. It is important only that an account title describe the item it represents.)

### Decision Insight



**Sporting Accounts** The **Los Angeles Lakers** and the other NBA teams have the following major revenue and expense accounts:

#### Revenues

Basketball ticket sales  
TV & radio broadcast fees  
Advertising revenues  
Basketball playoff receipts

#### Expenses

Team salaries  
Game costs  
NBA franchise costs  
Promotional costs ■



## ANALYZING AND PROCESSING TRANSACTIONS

This section explains several tools and processes that comprise an accounting system. These include a ledger, T-account, debits and credits, double-entry accounting, journalizing, and posting.

**C3** Describe a ledger and a chart of accounts.

### Ledger and Chart of Accounts

The collection of all accounts and their balances for an information system is called a *ledger* (or *general ledger*). If accounts are in files on a hard drive, the sum of those files is the ledger. If the accounts are pages in a file, that file is the ledger. A company's size and diversity of operations affect the number of accounts needed. A small company can get by with as few as 20 or 30 accounts; a large company can require several thousand. The **chart of accounts** is a list of all ledger accounts and includes an identification number assigned to each account. A small business might use the following numbering system for its accounts:

101–199	Asset accounts
201–299	Liability accounts
301–399	Equity accounts
401–499	Revenue accounts
501–699	Expense accounts



These numbers provide a three-digit code that is useful in recordkeeping. In this case, the first digit assigned to asset accounts is a 1, the first digit assigned to liability accounts is a 2, and so on. The second and third digits relate to the accounts' subcategories. Exhibit 2.4 shows a partial chart of accounts for FastForward, the focus company of Chapter 1. (Please review the more complete chart of accounts that follows the index at the back of this book.)

### EXHIBIT 2.4

Partial Chart of Accounts for FastForward

Acct. No.	Account Name	Acct. No.	Account Name	Acct. No.	Account Name
101	Cash	236	Unearned consulting revenue	406	Rental revenue
106	Accounts receivable			622	Salaries expense
126	Supplies	307	Common stock	637	Insurance expense
128	Prepaid insurance	318	Retained earnings	640	Rent expense
167	Equipment	319	Dividends	652	Supplies expense
201	Accounts payable	403	Consulting revenue	690	Utilities expense



## Debits and Credits

A **T-account** represents a ledger account and is a tool used to understand the effects of one or more transactions. Its name comes from its shape like the letter **T**. The layout of a T-account, shown in Exhibit 2.5, is (1) the account title on top, (2) a left, or debit side, and (3) a right, or credit, side.

The left side of an account is called the **debit** side, often abbreviated *Dr.* The right side is called the **credit** side, abbreviated *Cr.*<sup>2</sup> To enter amounts on the left side of an account is to *debit* the account. To enter amounts on the right side is to *credit* the account. Do not make the error of thinking that the terms *debit* and *credit* mean increase or decrease. Whether a debit or a credit is an increase or decrease depends on the account. For an account where a debit is an increase, the credit is a decrease; for an account where a debit is a decrease, the credit is an increase. The difference between total debits and total credits for an account, including any beginning balance, is the **account balance**. When the sum of debits exceeds the sum of credits, the account has a *debit balance*. It has a *credit balance* when the sum of credits exceeds the sum of debits. When the sum of debits equals the sum of credits, the account has a *zero balance*.

Account Title	
(Left side) <b>Debit</b>	(Right side) <b>Credit</b>

**C4** Define *debits* and *credits* and explain double-entry accounting.

### EXHIBIT 2.5

The T-Account

**Point:** Think of *debit* and *credit* as accounting directions for left and right.

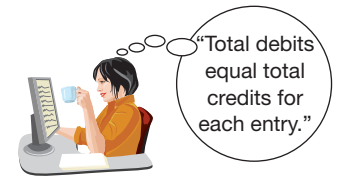
## Double-Entry Accounting

**Double-entry accounting** requires that for each transaction:

- At least two accounts are involved, with at least one debit and one credit.
- The total amount debited must equal the total amount credited.
- The accounting equation must not be violated.

This means the sum of the debits for all entries must equal the sum of the credits for all entries, and the sum of debit account balances in the ledger must equal the sum of credit account balances.

The system for recording debits and credits follows from the usual accounting equation—see Exhibit 2.6. Two points are important here. First, like any simple mathematical relation, net increases or decreases on one side have equal net effects on the other side. For example, a net increase in assets must be accompanied by an identical net increase on the liabilities and equity



Assets		=	Liabilities		+	Equity	
Debit for increases <b>+</b> Normal	Credit for decreases <b>-</b>		Debit for decreases <b>-</b>	Credit for increases <b>+</b> Normal		Debit for decreases <b>-</b>	Credit for increases <b>+</b> Normal

### EXHIBIT 2.6

Debits and Credits in the Accounting Equation

side. Recall that some transactions affect only one side of the equation, meaning that two or more accounts on one side are affected, but their net effect on this one side is zero. Second, the left side is the *normal balance* side for assets, and the right side is the *normal balance* side for liabilities and equity. This matches their layout in the accounting equation where assets are on the left side of this equation, and liabilities and equity are on the right.

Recall that equity increases from revenues and stock issuances, and it decreases from expenses and dividends. These important equity relations are conveyed by expanding the accounting equation to include debits and credits in double-entry form as shown in Exhibit 2.7.

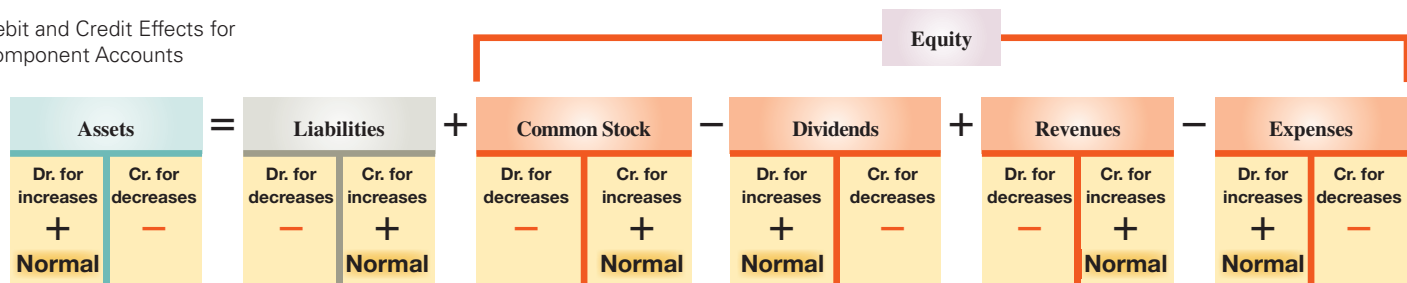
Increases (credits) to common stock and revenues *increase* equity; increases (debits) to dividends and expenses *decrease* equity. The normal balance of each account (asset, liability, common stock, dividends, revenue, or expense) refers to the left or right (debit or credit) side where

**Point:** Debits and credits do not mean favorable or unfavorable. A debit to an asset increases it, as does a debit to an expense. A credit to a liability increases it, as does a credit to a revenue.

<sup>2</sup> These abbreviations are remnants of 18th-century English recordkeeping practices where the terms *debtor* and *creditor* were used instead of *debit* and *credit*. The abbreviations use the first and last letters of these terms, just as we still do for Saint (St.) and Doctor (Dr.).

**EXHIBIT 2.7**

Debit and Credit Effects for Component Accounts



increases are recorded. Understanding these diagrams and rules is required to prepare, analyze, and interpret financial statements.

The T-account for FastForward's Cash account, reflecting its first 11 transactions (from Exhibit 1.9), is shown in Exhibit 2.8. The total increases in its Cash account are \$36,100, the total decreases are \$31,300, and the account's debit balance is \$4,800. (We illustrate use of T-accounts later in this chapter.)

**EXHIBIT 2.8**

Computing the Balance for a T-Account

Cash			
Receive investment by owner for stock	30,000	Purchase of supplies	2,500
Consulting services revenue earned	4,200	Purchase of equipment	26,000
Collection of account receivable	1,900	Payment of rent	1,000
		Payment of salary	700
		Payment of account payable	900
		Payment of cash dividend	200
Balance	<b>4,800</b>		

**Point:** The ending balance is on the side with the larger dollar amount. Also, a plus (+) and minus (-) are not used in a T-account.

**Quick Check**

Answers — p. 77



1. Identify examples of accounting source documents.
2. Explain the importance of source documents.
3. Identify each of the following as either an asset, a liability, or equity: (a) Prepaid Rent, (b) Unearned Fees, (c) Building, (d) Wages Payable, and (e) Office Supplies.
4. What is an account? What is a ledger?
5. What determines the number and types of accounts a company uses?
6. Does *debit* always mean increase and *credit* always mean decrease?
7. Describe a chart of accounts.

**Journalizing and Posting Transactions**

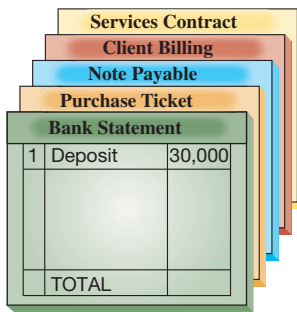
Processing transactions is a crucial part of accounting. The four usual steps of this process are depicted in Exhibit 2.9. Steps 1 and 2—involving transaction analysis and the accounting equation—were introduced in prior sections. This section extends that discussion and focuses on steps 3 and 4 of the accounting process. Step 3 is to record each transaction chronologically in a journal. A **journal** gives a complete record of each transaction in one place. It also shows debits and credits for each transaction. The process of recording transactions in a journal is called **journalizing**. Step 4 is to transfer (or *post*) entries from the journal to the ledger. The process of transferring journal entry information to the ledger is called **posting**.

**Journalizing Transactions** The process of journalizing transactions requires an understanding of a journal. While companies can use various journals, every company uses a **general journal**. It can be used to record any transaction and includes the following information about each transaction: (a) date of transaction, (b) titles of affected accounts, (c) dollar amount of each

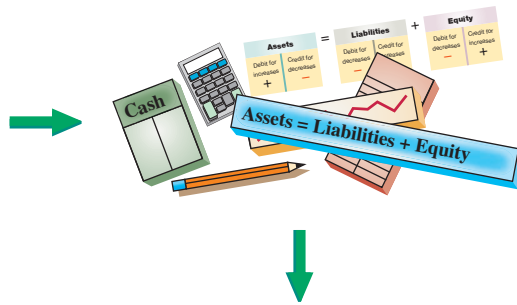
**P1** Record transactions in a journal and post entries to a ledger.



**Step 1:** Identify transactions and source documents.



**Step 2:** Analyze transactions using the accounting equation.



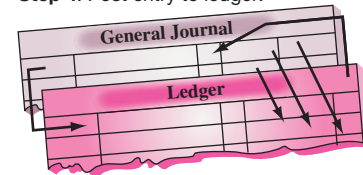
**EXHIBIT 2.9**

Steps in Processing Transactions

**Step 3:** Record journal entry.

General Journal			
Dec. 1	Cash	30,000	
	Common Stock		30,000
Dec. 2	Supplies	2,500	
	Cash		2,500

**Step 4:** Post entry to ledger.



debit and credit, and ① explanation of the transaction. Exhibit 2.10 shows how the first two transactions of FastForward are recorded in a general journal. This process is similar for manual and computerized systems. Computerized journals are often designed to look like a manual journal page, and also include error-checking routines that ensure debits equal credits for each entry. Shortcuts allow recordkeepers to select account names and numbers from pull-down menus.

Date	Account Titles and Explanation	PR	Debit	Credit
2011 Dec. 1	Cash		30,000	
	Common Stock			30,000
	<i>Receive investment by owner.</i>			
Dec. 2	Supplies		2,500	
	Cash			2,500
	<i>Purchase supplies for cash.</i>			

**EXHIBIT 2.10**

Partial General Journal for FastForward

To record entries in a general journal, apply these steps; refer to the entries in Exhibit 2.10 when reviewing these steps. (1) Date the transaction: Enter the year at the top of the first column and the month and day on the first line of each journal entry. (2) Enter titles of accounts debited and then enter amounts in the Debit column on the same line. Account titles are taken from the chart of accounts and are aligned with the left margin of the Account Titles and Explanation column. (3) Enter titles of accounts credited and then enter amounts in the Credit column on the same line. Account titles are from the chart of accounts and are indented from the left margin of the Account Titles and Explanation column to distinguish them from debited accounts. (4) Enter a brief explanation of the transaction on the line below the entry (it often references a source document). This explanation is indented about half as far as the credited account titles to avoid confusing it with accounts, and it is italicized.

**Point:** There are no exact rules for writing journal entry explanations. An explanation should be short yet describe why an entry is made.

**IFRS**

IFRS requires that companies report the following four basic financial statements with explanatory notes:

- Balance sheet
- Statement of changes in equity (or statement of recognized revenue and expense)
- Income statement
- Statement of cash flows

IFRS does not prescribe specific formats, and comparative information is required for the preceding period only. ●



A blank line is left between each journal entry for clarity. When a transaction is first recorded, the **posting reference (PR) column** is left blank (in a manual system). Later, when posting entries to the ledger, the identification numbers of the individual ledger accounts are entered in the PR column.

**Balance Column Account** T-accounts are simple and direct means to show how the accounting process works. However, actual accounting systems need more structure and therefore use **balance column accounts**, such as that in Exhibit 2.11.

### EXHIBIT 2.11

Cash Account in Balance Column Format

Cash			Account No. 101		
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1		G1	30,000		30,000
Dec. 2		G1		2,500	27,500
Dec. 3		G1		26,000	1,500
Dec. 10		G1	4,200		5,700

The balance column account format is similar to a T-account in having columns for debits and credits. It is different in including transaction date and explanation columns. To illustrate, FastForward's Cash account in Exhibit 2.11 is debited on December 1 for the \$30,000 owner investment, yielding a \$30,000 debit balance. The account is credited on December 2 for \$2,500, yielding a \$27,500 debit balance. On December 3, it is credited again, this time for \$26,000, and its debit balance is reduced to \$1,500. The Cash account is debited for \$4,200 on December 10, and its debit balance increases to \$5,700; and so on.

The heading of the Balance column does not show whether it is a debit or credit balance. Instead, an account is assumed to have a *normal balance*. Unusual events can sometimes temporarily

**Point:** Explanations are typically included in ledger accounts only for unusual transactions or events.

### EXHIBIT 2.12

Posting an Entry to the Ledger

The screenshot displays two windows from Peachtree Accounting: 'General Journal Entry' and 'General Ledger Trial Balance'. The journal entry window shows a debit to Cash (Account 101) and a credit to Common Stock (Account 307) for \$30,000 on Dec 1, 2011. The ledger window shows the corresponding entries in the Cash and Common Stock accounts. Red arrows and numbers 1-4 indicate the flow of data from the journal to the ledger.

**Point:** The fundamental concepts of a manual (pencil-and-paper) system are identical to those of a computerized information system.

- Key:
- ① Identify debit account in Ledger: enter date, journal page, amount, and balance.
  - ② Enter the debit account number from the Ledger in the PR column of the journal.
  - ③ Identify credit account in Ledger: enter date, journal page, amount, and balance.
  - ④ Enter the credit account number from the Ledger in the PR column of the journal.



give an account an abnormal balance. An *abnormal balance* refers to a balance on the side where decreases are recorded. For example, a customer might mistakenly overpay a bill. This gives that customer's account receivable an abnormal (credit) balance. An abnormal balance is often identified by circling it or by entering it in red or some other unusual color. A zero balance for an account is usually shown by writing zeros or a dash in the Balance column to avoid confusion between a zero balance and one omitted in error.

**Posting Journal Entries** Step 4 of processing transactions is to post journal entries to ledger accounts (see Exhibit 2.9). To ensure that the ledger is up-to-date, entries are posted as soon as possible. This might be daily, weekly, or when time permits. All entries must be posted to the ledger before financial statements are prepared to ensure that account balances are up-to-date. When entries are posted to the ledger, the debits in journal entries are transferred into ledger accounts as debits, and credits are transferred into ledger accounts as credits. Exhibit 2.12 shows the *four steps to post a journal entry*. First, identify the ledger account that is debited in the entry; then, in the ledger, enter the entry date, the journal and page in its PR column, the debit amount, and the new balance of the ledger account. (The letter *G* shows it came from the General Journal.) Second, enter the ledger account number in the PR column of the journal. Steps 3 and 4 repeat the first two steps for credit entries and amounts. The posting process creates a link between the ledger and the journal entry. This link is a useful cross-reference for tracing an amount from one record to another.

**Point:** Computerized systems often provide a code beside a balance such as *dr.* or *cr.* to identify its balance. Posting is automatic and immediate with accounting software.

**Point:** A journal is often referred to as the *book of original entry*. The ledger is referred to as the *book of final entry* because financial statements are prepared from it.

### Analyzing Transactions – An Illustration

We return to the activities of FastForward to show how double-entry accounting is useful in analyzing and processing transactions. Analysis of each transaction follows the four steps of Exhibit 2.9.

- Step 1** Identify the transaction and any source documents.
- Step 2** Analyze the transaction using the accounting equation.
- Step 3** Record the transaction in journal entry form applying double-entry accounting.
- Step 4** Post the entry (for simplicity, we use T-accounts to represent ledger accounts).

**A1** Analyze the impact of transactions on accounts and financial statements.

Study each transaction thoroughly before proceeding to the next. The first 11 transactions are from Chapter 1, and we analyze five additional December transactions of FastForward (numbered 12 through 16) that were omitted earlier.

#### 1. Receive Investment by Owner

**1 IDENTIFY** FastForward receives \$30,000 cash from Chas Taylor in exchange for common stock.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Cash</b>				<b>Common Stock</b>
+30,000		= 0		+ 30,000

**3 RECORD**

	(1)	Cash	101	30,000		
		Common Stock	307			30,000

**4 POST**

		<b>Cash</b>		101
	(1)	30,000		
		<b>Common Stock</b>		307
		(1) 30,000		



#### 2. Purchase Supplies for Cash

**1 IDENTIFY** FastForward pays \$2,500 cash for supplies.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Cash</b>				<b>Supplies</b>
-2,500		+2,500		= 0 + 0

Changes the composition of assets but not the total.

**3 RECORD**

	(2)	Supplies	126	2,500		
		Cash	101			2,500

**4 POST**

		<b>Supplies</b>		126
	(2)	2,500		
		<b>Cash</b>		101
	(1)	30,000	(2)	2,500



### 3. Purchase Equipment for Cash

**1 IDENTIFY** FastForward pays \$26,000 cash for equipment.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash	Equipment				
-26,000	+26,000	=	0	+	0

Changes the composition of assets but not the total.

**3 RECORD**

(3)	Equipment	167	26,000	
	Cash	101		26,000

**4 POST**

Equipment		167
(3)	26,000	

Cash		101
(1)	30,000	(2) 2,500
		(3) 26,000

### 4. Purchase Supplies on Credit

**1 IDENTIFY** FastForward purchases \$7,100 of supplies on credit from a supplier.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Supplies			Accounts Payable		
+7,100		=	+7,100	+	0

**3 RECORD**

(4)	Supplies	126	7,100	
	Accounts Payable	201		7,100

**4 POST**

Supplies		126
(2)	2,500	
(4)	7,100	

Accounts Payable		201
		(4) 7,100

### 5. Provide Services for Cash

**1 IDENTIFY** FastForward provides consulting services and immediately collects \$4,200 cash.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash			Consulting Revenue		
+4,200		=	0	+	+4,200

**3 RECORD**

(5)	Cash	101	4,200	
	Consulting Revenue	403		4,200

**4 POST**

Cash		101
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000

Consulting Revenue		403
		(5) 4,200

### 6. Payment of Expense in Cash

**1 IDENTIFY** FastForward pays \$1,000 cash for December rent.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash			Rent Expense		
-1,000		=	0	+	-1,000

**3 RECORD**

(6)	Rent Expense	640	1,000	
	Cash	101		1,000

**4 POST**

Rent Expense		640
(6)	1,000	

Cash		101
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000
		(6) 1,000

### 7. Payment of Expense in Cash

**1 IDENTIFY** FastForward pays \$700 cash for employee salary.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash			Salaries Expense		
-700		=	0	+	-700

**3 RECORD**

(7)	Salaries Expense	622	700	
	Cash	101		700

**4 POST**

Salaries Expense		622
(7)	700	

Cash		101
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000
		(6) 1,000
		(7) 700

**Point:** *Salary* usually refers to compensation for an employee who receives a fixed amount for a given time period, whereas *wages* usually refers to compensation based on time worked.



### 8. Provide Consulting and Rental Services on Credit

**1 IDENTIFY** FastForward provides consulting services of \$1,600 and rents its test facilities for \$300. The customer is billed \$1,900 for these services.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Accounts Receivable</b>				<b>Consulting Revenue</b>
+1,900	=	0	+	+1,600 +300

**3 RECORD**

(8)	Accounts Receivable	106	1,900	
	Consulting Revenue	403		1,600
	Rental Revenue	406		300

**4 POST**

<b>Accounts Receivable</b>		<b>106</b>
(8)	1,900	
<b>Consulting Revenue</b>		<b>403</b>
	(5)	4,200
	(8)	1,600
<b>Rental Revenue</b>		<b>406</b>
	(8)	300

**Point:** Transaction 8 is a **compound journal entry**, which affects three or more accounts.

### 9. Receipt of Cash on Account

**1 IDENTIFY** FastForward receives \$1,900 cash from the client billed in transaction 8.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Cash</b>				
+1,900	=	0	+	0

**3 RECORD**

(9)	Cash	101	1,900	
	Accounts Receivable	106		1,900

**4 POST**

<b>Cash</b>		<b>101</b>
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000
(9)	1,900	(6) 1,000
		(7) 700
<b>Accounts Receivable</b>		<b>106</b>
(8)	1,900	(9) 1,900

**Point:** The *revenue recognition principle* requires revenue to be recognized when earned, which is when the company provides products and services to a customer. This is not necessarily the same time that the customer pays. A customer can pay before or after products or services are provided.

### 10. Partial Payment of Accounts Payable

**1 IDENTIFY** FastForward pays CalTech Supply \$900 cash toward the payable of transaction 4.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Cash</b>				
-900	=	-900	+	0

**3 RECORD**

(10)	Accounts Payable	201	900	
	Cash	101		900

**4 POST**

<b>Accounts Payable</b>		<b>201</b>
(10)	900	(4) 7,100
<b>Cash</b>		<b>101</b>
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000
(9)	1,900	(6) 1,000
		(7) 700
		(10) 900
		<b>(10) 900</b>

### 11. Payment of Cash Dividend

**1 IDENTIFY** FastForward pays \$200 cash for dividends

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
<b>Cash</b>				
-200	=	0		-200

**3 RECORD**

(11)	Dividends	319	200	
	Cash	101		200

**4 POST**

<b>Dividends</b>		<b>319</b>
(11)	200	
<b>Cash</b>		<b>101</b>
(1)	30,000	(2) 2,500
(5)	4,200	(3) 26,000
(9)	1,900	(6) 1,000
		(7) 700
		(10) 900
		<b>(11) 200</b>



### 12. Receipt of Cash for Future Services

**1 IDENTIFY** FastForward receives \$3,000 cash in advance of providing consulting services to a customer.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash			Unearned Consulting Revenue		
+3,000		=	+3,000	+	0

Accepting \$3,000 cash obligates FastForward to perform future services and is a liability. No revenue is earned until services are provided.

**3 RECORD**

(12)	Cash	101	3,000	
	Unearned Consulting Revenue	236		3,000

**4 POST**

Cash		101	
(1)	30,000	(2)	2,500
(5)	4,200	(3)	26,000
(9)	1,900	(6)	1,000
(12)	<b>3,000</b>	(7)	700
		(10)	900
		(11)	200

Unearned Consulting Revenue		236	
(12)	<b>3,000</b>		

**Point:** Luca Pacioli, a 15th-century monk, is considered a pioneer in accounting and the first to devise double-entry accounting.

### 13. Pay Cash for Future Insurance Coverage

**1 IDENTIFY** FastForward pays \$2,400 cash (insurance premium) for a 24-month insurance policy. Coverage begins on December 1.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash	Prepaid Insurance				
-2,400	+2,400	=	0	+	0

Changes the composition of assets from cash to prepaid insurance. Expense is incurred as insurance coverage expires.

**3 RECORD**

(13)	Prepaid Insurance	128	2,400	
	Cash	101		2,400

**4 POST**

Prepaid Insurance		128	
(13)	<b>2,400</b>		

Cash		101	
(1)	30,000	(2)	2,500
(5)	4,200	(3)	26,000
(9)	1,900	(6)	1,000
(12)	3,000	(7)	700
		(10)	900
		(11)	200
		(13)	<b>2,400</b>

### 14. Purchase Supplies for Cash

**1 IDENTIFY** FastForward pays \$120 cash for supplies.

**2 ANALYZE**

Assets		=	Liabilities	+	Equity
Cash	Supplies				
-120	+120	=	0	+	0

**3 RECORD**

(14)	Supplies	126	120	
	Cash	101		120

**4 POST**

Supplies		126	
(2)	2,500		
(4)	7,100		
(14)	<b>120</b>		

Cash		101	
(1)	30,000	(2)	2,500
(5)	4,200	(3)	26,000
(9)	1,900	(6)	1,000
(12)	3,000	(7)	700
		(10)	900
		(11)	200
		(13)	2,400
		(14)	<b>120</b>



### 15. Payment of Expense in Cash

**1 IDENTIFY** FastForward pays \$230 cash for December utilities expense.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
Cash				Utilities Expense
-230		=	0	-230

**3 RECORD**

(15)	Utilities Expense	690	230	
	Cash	101		230

**4 POST**

Utilities Expense		690
(15)	230	

Cash		101	
(1)	30,000	(2)	2,500
(5)	4,200	(3)	26,000
(9)	1,900	(6)	1,000
(12)	3,000	(7)	700
		(10)	900
		(11)	200
		(13)	2,400
		(14)	120
		(15)	230

### 16. Payment of Expense in Cash

**1 IDENTIFY** FastForward pays \$700 cash in employee salary for work performed in the latter part of December.

**2 ANALYZE**

Assets	=	Liabilities	+	Equity
Cash				Salaries Expense
-700		=	0	-700

**3 RECORD**

(16)	Salaries Expense	622	700	
	Cash	101		700

**4 POST**

Salaries Expense		622
(7)	700	
(16)	700	

Cash		101	
(1)	30,000	(2)	2,500
(5)	4,200	(3)	26,000
(9)	1,900	(6)	1,000
(12)	3,000	(7)	700
		(10)	900
		(11)	200
		(13)	2,400
		(14)	120
		(15)	230
		(16)	700

**Point:** We could merge transactions 15 and 16 into one compound entry.

## Accounting Equation Analysis

Exhibit 2.13 shows the ledger accounts (in T-account form) of FastForward after all 16 transactions are recorded and posted and the balances computed. The accounts are grouped into three major columns corresponding to the accounting equation: assets, liabilities, and equity. Note several important points. First, as with each transaction, the totals for the three columns must obey the accounting equation. Specifically, assets equal \$42,470 (\$4,350 + \$0 + \$9,720 + \$2,400 + \$26,000); liabilities equal \$9,200 (\$6,200 + \$3,000); and equity equals \$33,270 (\$30,000 - \$200 + \$5,800 + \$300 - \$1,400 - \$1,000 - \$230). These numbers prove the accounting equation: Assets of \$42,470 = Liabilities of \$9,200 + Equity of \$33,270. Second, the common stock, dividends, revenue, and expense accounts reflect the transactions that change equity. The latter three account categories underlie the statement of retained earnings. Third, the revenue and expense account balances will be summarized and reported in the income statement. Fourth, increases and decreases in the cash account make up the elements reported in the statement of cash flows.

Accounts	Debit and Credit Rules	
	Increase (normal bal.)	Decrease
Asset .....	Debit	Credit
Liability .....	Credit	Debit
Common stock .....	Credit	Debit
Dividends .....	Debit	Credit
Revenue .....	Credit	Debit
Expense .....	Debit	Credit

**Point:** Technology does not provide the judgment required to analyze most business transactions. Analysis requires the expertise of skilled and ethical professionals.





## TRIAL BALANCE

Double-entry accounting requires the sum of debit account balances to equal the sum of credit account balances. A trial balance is used to confirm this. A **trial balance** is a list of accounts and their balances at a point in time. Account balances are reported in their appropriate debit or credit columns of a trial balance. A trial balance can be used to confirm this and to follow up on any abnormal or unusual balances. Exhibit 2.14 shows the trial balance for FastForward after its 16 entries have been posted to the ledger. (This is an *unadjusted* trial balance—Chapter 3 explains the necessary adjustments.)

FASTFORWARD Trial Balance December 31, 2011		
	Debit	Credit
Cash	\$ 4,350	
Accounts receivable	0	
Supplies	9,720	
Prepaid insurance	2,400	
Equipment	26,000	
Accounts payable		\$ 6,200
Unearned consulting revenue		3,000
Common stock		30,000
Dividends	200	
Consulting revenue		5,800
Rental revenue		300
Salaries expense	1,400	
Rent expense	1,000	
Utilities expense	230	
Totals	\$ 45,300	\$ 45,300

### EXHIBIT 2.14

Trial Balance (Unadjusted)

**Point:** The ordering of accounts in a trial balance typically follows their identification number from the chart of accounts.

## Preparing a Trial Balance

Preparing a trial balance involves three steps:

1. List each account title and its amount (from ledger) in the trial balance. If an account has a zero balance, list it with a zero in its normal balance column (or omit it entirely).
2. Compute the total of debit balances and the total of credit balances.
3. Verify (*prove*) total debit balances equal total credit balances.

**P2** Prepare and explain the use of a trial balance.



### Fraud

**Heavenly accounting.** Religious organizations are especially vulnerable to fraud. Due to “trust” among religious cohorts, the opportunity factor in the fraud triangle looms large for such entities. In many cases, the recording of transactions has few or no controls. For example, in 2011, a mother and son team from Morristown, Tennessee, pleaded guilty to defrauding a local church. They had recorded nearly 2,000 checks to “cash,” amounting to more than \$1.5 million, which they cashed and pocketed. An independent review of transactions or a requirement for documentation would have reduced the opportunity factor.



The total of debit balances equals the total of credit balances for the trial balance in Exhibit 2.14. Equality of these two totals does not guarantee that no errors were made. For example, the column totals still will be equal when a debit or credit of a correct amount is made to a wrong account. Another error that does not cause unequal column totals occurs when equal debits and credits of an incorrect amount are entered.

**Point:** A trial balance is not a financial statement but a mechanism for checking equality of debits and credits in the ledger. Financial statements do not have debit and credit columns.

**Example:** If a credit to Unearned Revenue was incorrectly posted from the journal as a credit to the Revenue ledger account, would the ledger still balance? Would the financial statements be correct? *Answers:* The ledger would balance, but liabilities would be understated, equity would be overstated, and income would be overstated (all because of overstated revenues).

**Point:** The IRS requires companies to keep records that can be audited.

**Searching for and Correcting Errors** If the trial balance does not balance (when its columns are not equal), the error (or errors) must be found and corrected. An efficient way to search for an error is to check the journalizing, posting, and trial balance preparation in *reverse order*. Step 1 is to verify that the trial balance columns are correctly added. If step 1 fails to find the error, step 2 is to verify that account balances are accurately entered from the ledger. Step 3 is to see whether a debit (or credit) balance is mistakenly listed in the trial balance as a credit (or debit). A clue to this error is when the difference between total debits and total credits equals twice the amount of the incorrect account balance. If the error is still undiscovered, Step 4 is to recompute each account balance in the ledger. Step 5 is to verify that each journal entry is properly posted. Step 6 is to verify that the original journal entry has equal debits and credits. At this point, the errors should be uncovered.<sup>3</sup>

If an error in a journal entry is discovered before the error is posted, it can be corrected in a manual system by drawing a line through the incorrect information. The correct information is written above it to create a record of change for the auditor. Many computerized systems allow the operator to replace the incorrect information directly.

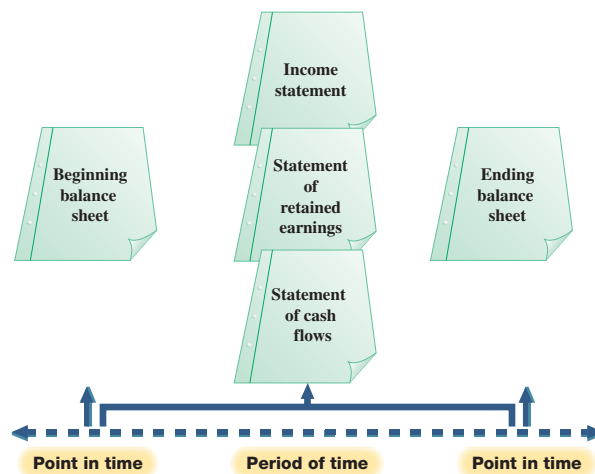
If an error in a journal entry is not discovered until after it is posted, we do not strike through both erroneous entries in the journal and ledger. Instead, we correct this error by creating a *correcting entry* that removes the amount from the wrong account and records it to the correct account. As an example, suppose a \$100 purchase of supplies is journalized with an incorrect debit to Equipment, and then this incorrect entry is posted to the ledger. The Supplies ledger account balance is understated by \$100, and the Equipment ledger account balance is overstated by \$100. The correcting entry is: debit Supplies and credit Equipment (both for \$100).

**P3** Prepare financial statements from business transactions.

## Using a Trial Balance to Prepare Financial Statements

This section shows how to prepare *financial statements* from the trial balance in Exhibit 2.14 and from information on the December transactions of FastForward. These statements differ from those in Chapter 1 because of several additional transactions. These statements are also more precisely called *unadjusted statements* because we need to make some further accounting adjustments (described in Chapter 3).

How financial statements are linked in time is illustrated in Exhibit 2.15. A balance sheet reports on an organization's financial position at a *point in time*. The income statement, statement of retained earnings, and statement of cash flows report on financial performance over a *period of time*. The three statements in the middle column of Exhibit 2.15 link balance sheets from the



### EXHIBIT 2.15

Links between Financial Statements across Time

<sup>3</sup> *Transposition* occurs when two digits are switched, or transposed, within a number. If transposition is the only error, it yields a difference between the two trial balance totals that is evenly divisible by 9. For example, assume that a \$691 debit in an entry is incorrectly posted to the ledger as \$619. Total credits in the trial balance are then larger than total debits by \$72 (\$691 - \$619). The \$72 error is *evenly* divisible by 9 ( $72/9 = 8$ ). The first digit of the quotient (in our example it is 8) equals the difference between the digits of the two transposed numbers (the 9 and the 1). The number of digits in the quotient also tells the location of the transposition, starting from the right. The quotient in our example had only one digit (8), so it tells us the transposition is in the first digit. Consider another example where a transposition error involves posting \$961 instead of the correct \$691. The difference in these numbers is \$270, and its quotient is 30 ( $270/9$ ). The quotient has two digits, so it tells us to check the second digit from the right for a transposition of two numbers that have a difference of 3.



beginning to the end of a reporting period. They explain how financial position changes from one point to another.

Preparers and users (including regulatory agencies) determine the length of the reporting period. A one-year, or annual, reporting period is common, as are semiannual, quarterly, and monthly periods. The one-year reporting period is known as the *accounting*, or *fiscal*, year. Businesses whose accounting year begins on January 1 and ends on December 31 are known as *calendar-year* companies. Many companies choose a fiscal year ending on a date other than December 31. **Research In Motion** is a *noncalendar-year* company as reflected in the headings of its February 27 year-end financial statements in Appendix A near the end of the book.

**Income Statement** An income statement reports the revenues earned less the expenses incurred by a business over a period of time. FastForward's income statement for December is shown at the top of Exhibit 2.16. Information about revenues and expenses is conveniently taken from the trial balance in Exhibit 2.14. Net income of \$3,470 is reported at the bottom of the statement. Owner investments and dividends are *not* part of income.

**Point:** A statement's heading lists the 3 W's: **Who**—name of organization, **What**—name of statement, **When**—statement's point in time or period of time.

FASTFORWARD Income Statement For Month Ended December 31, 2011		
Revenues		
Consulting revenue (\$4,200 + \$1,600) .....	\$ 5,800	
Rental revenue .....	<u>300</u>	
Total revenues .....		\$ 6,100
Expenses		
Rent expense .....	1,000	
Salaries expense .....	1,400	
Utilities expense .....	<u>230</u>	
Total expenses .....		<u>2,630</u>
Net income .....		<u><u>\$ 3,470</u></u>

### EXHIBIT 2.16

Financial Statements and Their Links

FASTFORWARD Statement of Retained Earnings For Month Ended December 31, 2011		
Retained earnings, December 1, 2011 .....	\$ 0	
Plus: Net income .....	<u>3,470</u>	
		3,470
Less: Cash dividends .....		<u>200</u>
Retained earnings, December 31, 2011 .....		<u><u>\$ 3,270</u></u>

**Point:** Arrow lines show how the statements are linked.

FASTFORWARD Balance Sheet December 31, 2011			
Assets		Liabilities	
Cash .....	\$ 4,350	Accounts payable .....	\$ 6,200
Supplies .....	9,720	Unearned revenue .....	<u>3,000</u>
Prepaid insurance ..	2,400	Total liabilities .....	9,200
Equipment .....	26,000	<b>Equity</b>	
		Common stock .....	30,000
		Retained earnings .....	<u>3,270</u>
		Total equity .....	<u>33,270</u>
Total assets .....	<u><u>\$42,470</u></u>	Total liabilities and equity ..	<u><u>\$42,470</u></u>

**Point:** To foot a column of numbers is to add them.



**Statement of Retained Earnings** The statement of retained earnings reports information about how retained earnings changes over the reporting period. FastForward's statement of retained earnings is the second report in Exhibit 2.16. It shows the \$3,470 of net income, the \$200 dividend, and the \$3,270 end-of-period balance. (The beginning balance in the statement of retained earnings is rarely zero; an exception is for the first period of operations. The beginning retained earnings balance in January 2012 is \$3,270, which is December's ending balance.)

**Point:** An income statement is also called an *earnings statement*, a *statement of operations*, or a *P&L (profit and loss) statement*. A balance sheet is also called a *statement of financial position*.

**Point:** While revenues increase equity, and expenses decrease equity, the amounts are not reported in detail in the statement of retained earnings. Instead, their effects are reflected through net income.

**Point:** Knowing how financial statements are prepared improves our analysis of them.

**Balance Sheet** The balance sheet reports the financial position of a company at a point in time, usually at the end of a month, quarter, or year. FastForward's balance sheet is the third report in Exhibit 2.16. This statement refers to financial condition at the close of business on December 31. The left side of the balance sheet lists its assets: cash, supplies, prepaid insurance, and equipment. The upper right side of the balance sheet shows that it owes \$6,200 to creditors and \$3,000 in services to customers who paid in advance. The equity section shows an ending balance of \$33,270. Note the link between the ending balance of the statement of retained earnings and the retained earnings balance. (Recall that this presentation of the balance sheet is called the *account form*: assets on the left and liabilities and equity on the right. Another presentation is the *report form*: assets on top, followed by liabilities and then equity. Either presentation is acceptable.)

**Presentation Issues** Dollar signs are not used in journals and ledgers. They do appear in financial statements and other reports such as trial balances. The usual practice is to put dollar signs beside only the first and last numbers in a column. **Research In Motion's** financial statements in Appendix A show this. When amounts are entered in a journal, ledger, or trial balance, commas are optional to indicate thousands, millions, and so forth. However, commas are always used in financial statements. Companies also commonly round amounts in reports to the nearest dollar, or even to a higher level. Research In Motion is typical of many companies in that it rounds its financial statement amounts to the nearest thousand or million. This decision is based on the perceived impact of rounding for users' business decisions.

**Reading and Using an Annual Report** An *annual report* is required of more than 10,000 corporations in the United States that trade their stock *publicly*. This requirement is imposed by the SEC. Another nearly 5 million corporations in the United States do not trade their shares publicly, and are called *private* or *closely held* corporations, which are not subject to SEC oversight.

Appendix A, near the end of this book, shows key excerpts from the annual report of **Research In Motion (RIM)**. This appendix also reproduces financial statements from the annual reports of **Apple**, **Palm**, and **Nokia**. The key excerpts are identified and explained on page A-1. Page A-3 includes a report on the audit of RIM's financial statements, and page A-4 has the report on internal controls over its financial reporting. Pages A-5 through A-8 report the four financial statements. Pages A-9 to A-18 contain footnotes that expand on details underlying those statements. We review and use the annual report for many business decisions, especially for valuing corporate stock.



## Quick Check

Answers — p. 77



14. Where are dollar signs typically entered in financial statements?
15. If a \$4,000 debit to Equipment in a journal entry is incorrectly posted to the ledger as a \$4,000 credit, and the ledger account has a resulting debit balance of \$20,000, what is the effect of this error on the Trial Balance column totals?
16. Describe the link between the income statement and the statement of retained earnings.
17. Explain the link between the balance sheet and the statement of retained earnings.
18. Define and describe revenues and expenses.
19. Define and describe assets, liabilities, and equity.



## GLOBAL VIEW

Financial accounting according to U.S. GAAP is similar, but not identical, to IFRS. This section discusses differences in analyzing and recording transactions, and with the preparation of financial statements.

**Analyzing and Recording Transactions** Both U.S. GAAP and IFRS include broad and similar guidance for financial accounting. As the FASB and IASB work toward a common conceptual framework over the next few years, even those differences will fade. Further, both U.S. GAAP and IFRS apply transaction analysis and recording as shown in this chapter—using the same debit and credit system and accrual accounting. Although some variations exist in revenue and expense recognition and other accounting principles, all of the transactions in this chapter are accounted for identically under these two systems.

**Financial Statements** Both U.S. GAAP and IFRS prepare the same four basic financial statements. A few differences within each statement do exist and we will discuss those throughout the book. For example, both U.S. GAAP and IFRS require balance sheets to separate current items from noncurrent items. However, while U.S. GAAP balance sheets report current items first, IFRS balance sheets normally (but are not required to) present noncurrent items first, and equity before liabilities. To illustrate, a condensed version of **Nokia**'s balance sheet follows (numbers using euros in millions).

**NOKIA**

NOKIA Balance Sheet (in EUR millions) December 31, 2009			
Assets		Equity and Liabilities	
Noncurrent assets . . . . .	12,125	Total equity . . . . .	14,749
Current assets . . . . .	23,613	Noncurrent liabilities . . . . .	5,801
		Current liabilities . . . . .	15,188
Total assets . . . . .	<u>35,738</u>	Total equity and liabilities . . . . .	<u>35,738</u>

**Accounting Controls and Assurance** Accounting systems depend on control procedures that assure the proper principles were applied in processing accounting information. The passage of SOX legislation strengthened U.S. control procedures in recent years. However, global standards for control are diverse and so are enforcement activities. Consequently, while global accounting standards are converging, their application in different countries can yield different outcomes depending on the quality of their auditing standards and enforcement.



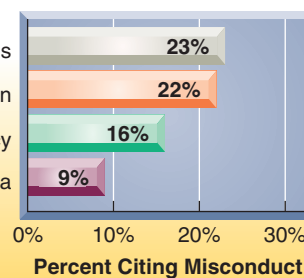
## Fraud

### Accounting control.

Recording valid transactions, and not recording fraudulent transactions, enhances the quality of financial statements. The graph here shows the percentage of employees in information technology that report observing specific types of misconduct within the past year.

[Source: KPMG 2009]

Breaching database controls  
 Mishandling private information  
 Breaching customer privacy  
 Falsifying accounting data





## Decision Analysis



## Debt Ratio

**A2** Compute the debt ratio and describe its use in analyzing financial condition.

An important business objective is gathering information to help assess a company's risk of failing to pay its debts. Companies finance their assets with either liabilities or equity. A company that finances a relatively large portion of its assets with liabilities is said to have a high degree of *financial leverage*. Higher financial leverage involves greater risk because liabilities must be repaid and often require regular interest payments (equity financing does not). The risk that a company might not be able to meet such required payments is higher if it has more liabilities (is more highly leveraged). One way to assess the risk associated with a company's use of liabilities is to compute the **debt ratio** as in Exhibit 2.17.

**EXHIBIT 2.17**

Debt Ratio

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

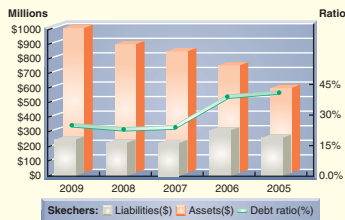
**Point:** Compare the equity amount to the liability amount to assess the extent of owner versus nonowner financing.

To see how to apply the debt ratio, let's look at **Skechers's** liabilities and assets. The company designs, markets, and sells footwear for men, women, and children under the Skechers brand. Exhibit 2.18 computes and reports its debt ratio at the end of each year from 2005 to 2009.

**EXHIBIT 2.18**

Computation and Analysis of Debt Ratio

\$ in millions	2009	2008	2007	2006	2005
Total liabilities . . . . .	\$246	\$204	\$201	\$288	\$238
Total assets . . . . .	\$996	\$876	\$828	\$737	\$582
<b>Debt ratio . . . . .</b>	<b>0.25</b>	<b>0.23</b>	<b>0.24</b>	<b>0.39</b>	<b>0.41</b>
Industry debt ratio . . . . .	0.51	0.50	0.46	0.48	0.47



Skechers's debt ratio ranges from a low of 0.23 to a high of 0.41—also, see graph in margin. Its ratio is lower, and has been generally declining, compared with the industry ratio. This analysis implies a low risk from its financial leverage. Is financial leverage good or bad for Skechers? To answer that question we need to compare the company's return on the borrowed money to the rate it is paying creditors. If the company's return is higher, it is successfully borrowing money to make more money. A company's success with making money from borrowed money can quickly turn unprofitable if its own return drops below the rate it is paying creditors.

**Decision Maker**

Answer — p. 76



**Investor** You consider buying stock in **Converse**. As part of your analysis, you compute its debt ratio for 2009, 2010, and 2011 as: 0.35, 0.74, and 0.94, respectively. Based on the debt ratio, is Converse a low-risk investment? Has the risk of buying Converse stock changed over this period? (The industry debt ratio averages 0.40.) ■

**DEMONSTRATION PROBLEM**

(This problem extends the demonstration problem of Chapter 1.) After several months of planning, Jasmine Worthy started a haircutting business called Expressions. The following events occurred during its first month.

- On August 1, Worthy invested \$3,000 cash and \$15,000 of equipment in Expressions in exchange for common stock.
- On August 2, Expressions paid \$600 cash for furniture for the shop.
- On August 3, Expressions paid \$500 cash to rent space in a strip mall for August.
- On August 4, it purchased \$1,200 of equipment on credit for the shop (using a long-term note payable).
- On August 5, Expressions opened for business. Cash received from haircutting services in the first week and a half of business (ended August 15) was \$825.
- On August 15, it provided \$100 of haircutting services on account.
- On August 17, it received a \$100 check for services previously rendered on account.
- On August 17, it paid \$125 to an assistant for hours worked during the grand opening.
- Cash received from services provided during the second half of August was \$930.



- j. On August 31, it paid a \$400 installment toward principal on the note payable entered into on August 4.  
 k. On August 31, it paid \$900 cash for dividends.

### Required

- Open the following ledger accounts in balance column format (account numbers are in parentheses): Cash (101); Accounts Receivable (102); Furniture (161); Store Equipment (165); Note Payable (240); Common Stock (307); Dividends (319); Haircutting Services Revenue (403); Wages Expense (623); and Rent Expense (640). Prepare general journal entries for the transactions.
- Post the journal entries from (1) to the ledger accounts.
- Prepare a trial balance as of August 31.
- Prepare an income statement for August.
- Prepare a statement of retained earnings for August.
- Prepare a balance sheet as of August 31.
- Determine the debt ratio as of August 31.

### Extended Analysis

- In the coming months, Expressions will experience a greater variety of business transactions. Identify which accounts are debited and which are credited for the following transactions. (*Hint: We must use some accounts not opened in part 1.*)
  - Purchase supplies with cash.
  - Pay cash for future insurance coverage.
  - Receive cash for services to be provided in the future.
  - Purchase supplies on account.

## PLANNING THE SOLUTION

- Analyze each transaction and use the debit and credit rules to prepare a journal entry for each.
- Post each debit and each credit from journal entries to their ledger accounts and cross-reference each amount in the posting reference (PR) columns of the journal and ledger.
- Calculate each account balance and list the accounts with their balances on a trial balance.
- Verify that total debits in the trial balance equal total credits.
- To prepare the income statement, identify revenues and expenses. List those items on the statement, compute the difference, and label the result as *net income* or *net loss*.
- Use information in the ledger to prepare the statement of retained earnings.
- Use information in the ledger to prepare the balance sheet.
- Calculate the debt ratio by dividing total liabilities by total assets.
- Analyze the future transactions to identify the accounts affected and apply debit and credit rules.

## SOLUTION TO DEMONSTRATION PROBLEM

- General journal entries:

General Journal Entry				
Date	Account Titles and Explanation	PR	Debit	Credit
Aug. 1	Cash .....	101	3,000	
	Store Equipment .....	165	15,000	
	Common Stock .....	307		18,000
	<i>Owner's investment for stock.</i>			
2	Furniture .....	161	600	
	Cash .....	101		600
	<i>Purchased furniture for cash.</i>			
3	Rent Expense .....	640	500	
	Cash .....	101		500
	<i>Paid rent for August.</i>			
4	Store Equipment .....	165	1,200	
	Note Payable .....	240		1,200
	<i>Purchased additional equipment on credit.</i>			

[continued on next page]



[continued from previous page]

15	Cash	101	825	
	Haircutting Services Revenue	403		825
	<i>Cash receipts from first half of August.</i>			
15	Accounts Receivable	102	100	
	Haircutting Services Revenue	403		100
	<i>To record revenue for services provided on account.</i>			
17	Cash	101	100	
	Accounts Receivable	102		100
	<i>To record cash received as payment on account.</i>			
17	Wages Expense	623	125	
	Cash	101		125
	<i>Paid wages to assistant.</i>			
31	Cash	101	930	
	Haircutting Services Revenue	403		930
	<i>Cash receipts from second half of August.</i>			
31	Note Payable	240	400	
	Cash	101		400
	<i>Paid an installment on the note payable.</i>			
31	Dividends	319	900	
	Cash	101		900
	<i>Paid cash dividend.</i>			

## 2. Post journal entries from part 1 to the ledger accounts:

General Ledger				
<b>Cash</b> Account No. 101				
Date	PR	Debit	Credit	Balance
Aug. 1	GI	3,000		3,000
2	GI		600	2,400
3	GI		500	1,900
15	GI	825		2,725
17	GI	100		2,825
17	GI		125	2,700
31	GI	930		3,630
31	GI		400	3,230
31	GI		900	2,330
<b>Accounts Receivable</b> Account No. 102				
Date	PR	Debit	Credit	Balance
Aug. 15	GI	100		100
17	GI		100	0
<b>Furniture</b> Account No. 161				
Date	PR	Debit	Credit	Balance
Aug. 2	GI	600		600
<b>Store Equipment</b> Account No. 165				
Date	PR	Debit	Credit	Balance
Aug. 1	GI	15,000		15,000
4	GI	1,200		16,200
<b>Note Payable</b> Account No. 240				
Date	PR	Debit	Credit	Balance
Aug. 4	GI		1,200	1,200
31	GI	400		800
<b>Common Stock</b> Account No. 307				
Date	PR	Debit	Credit	Balance
Aug. 1	GI		18,000	18,000
<b>Dividends</b> Account No. 319				
Date	PR	Debit	Credit	Balance
Aug. 31	GI	900		900
<b>Haircutting Services Revenue</b> Account No. 403				
Date	PR	Debit	Credit	Balance
Aug. 15	GI		825	825
15	GI		100	925
31	GI		930	1,855
<b>Wages Expense</b> Account No. 623				
Date	PR	Debit	Credit	Balance
Aug. 17	GI	125		125
<b>Rent Expense</b> Account No. 640				
Date	PR	Debit	Credit	Balance
Aug. 3	GI	500		500



3. Prepare a trial balance from the ledger:

<b>EXPRESSIONS</b>		
Trial Balance		
August 31		
	<u>Debit</u>	<u>Credit</u>
Cash .....	\$ 2,330	
Accounts receivable .....	0	
Furniture .....	600	
Store equipment .....	16,200	
Note payable .....		\$ 800
Common stock .....		18,000
Dividends .....	900	
Haircutting services revenue .....		1,855
Wages expense .....	125	
Rent expense .....	500	
Totals .....	<u>\$20,655</u>	<u>\$20,655</u>

4.

<b>EXPRESSIONS</b>		
Income Statement		
For Month Ended August 31		
Revenues		
Haircutting services revenue .....		\$1,855
Operating expenses		
Rent expense .....	\$500	
Wages expense .....	<u>125</u>	
Total operating expenses .....		<u>625</u>
Net income .....		<u>\$1,230</u>

5.

<b>EXPRESSIONS</b>		
Statement of Retained Earnings		
For Month Ended August 31		
Retained earnings, August 1 .....	\$ 0	
Plus: Net income .....	<u>1,230</u>	
		1,230
Less: Cash dividends .....	<u>900</u>	
Retained earnings, August 31 .....		<u>\$ 330</u>

6.

<b>EXPRESSIONS</b>			
Balance Sheet			
August 31			
<b>Assets</b>		<b>Liabilities</b>	
Cash .....	\$ 2,330	Note payable .....	\$ 800
Furniture .....	600	<b>Equity</b>	
Store equipment .....	16,200	Common stock .....	18,000
		Retained earnings .....	<u>330</u>
		Total equity .....	<u>18,330</u>
Total assets .....	<u>\$19,130</u>	Total liabilities and equity .....	<u>\$19,130</u>



$$7. \text{ Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}} = \frac{\$800}{\$19,130} = \underline{\underline{4.18\%}}$$

8a. Supplies debited  
Cash credited

8b. Prepaid Insurance debited  
Cash credited

8c. Cash debited  
Unearned Services Revenue credited

8d. Supplies debited  
Accounts Payable credited

## Summary

**C1 Explain the steps in processing transactions and the role of source documents.** The accounting process identifies business transactions and events, analyzes and records their effects, and summarizes and prepares information useful in making decisions. Transactions and events are the starting points in the accounting process. Source documents identify and describe transactions and events. Examples are sales tickets, checks, purchase orders, bills, and bank statements. Source documents provide objective and reliable evidence, making information more useful. The effects of transactions and events are recorded in journals. Posting along with a trial balance helps summarize and classify these effects.

**C2 Describe an account and its use in recording transactions.** An account is a detailed record of increases and decreases in a specific asset, liability, equity, revenue, or expense. Information from accounts is analyzed, summarized, and presented in reports and financial statements for decision makers.

**C3 Describe a ledger and a chart of accounts.** The ledger (or general ledger) is a record containing all accounts used by a company and their balances. It is referred to as the *books*. The chart of accounts is a list of all accounts and usually includes an identification number assigned to each account.

**C4 Define debits and credits and explain double-entry accounting.** *Debit* refers to left, and *credit* refers to right. Debits increase assets, expenses, and dividends while credits decrease them. Credits increase liabilities, common stock, and revenues; debits decrease them. Double-entry accounting means each transaction affects at least two accounts and has at least one debit and one credit. The system for recording debits and credits follows from the accounting equation. The left side of an account is the normal balance for assets, dividends, and expenses, and the right

side is the normal balance for liabilities, common stock, and revenues.

**A1 Analyze the impact of transactions on accounts and financial statements.** We analyze transactions using concepts of double-entry accounting. This analysis is performed by determining a transaction's effects on accounts. These effects are recorded in journals and posted to ledgers.

**A2 Compute the debt ratio and describe its use in analyzing financial condition.** A company's debt ratio is computed as total liabilities divided by total assets. It reveals how much of the assets are financed by creditor (nonowner) financing. The higher this ratio, the more risk a company faces because liabilities must be repaid at specific dates.

**P1 Record transactions in a journal and post entries to a ledger.** Transactions are recorded in a journal. Each entry in a journal is posted to the accounts in the ledger. This provides information that is used to produce financial statements. Balance column accounts are widely used and include columns for debits, credits, and the account balance.

**P2 Prepare and explain the use of a trial balance.** A trial balance is a list of accounts from the ledger showing their debit or credit balances in separate columns. The trial balance is a summary of the ledger's contents and is useful in preparing financial statements and in revealing recordkeeping errors.

**P3 Prepare financial statements from business transactions.** The balance sheet, the statement of retained earnings, the income statement, and the statement of cash flows use data from the trial balance (and other financial statements) for their preparation.

### Guidance Answers to Decision Maker and Decision Ethics



**Cashier** The advantages to the process proposed by the assistant manager include improved customer service, fewer delays, and less work for you. However, you should have serious concerns about internal control and the potential for fraud. In particular, the assistant manager could steal cash and simply enter fewer sales to match the remaining cash. You should reject her suggestion without the manager's approval. Moreover, you should have an ethical concern about the assistant manager's suggestion to ignore store policy.

**Investor** The debt ratio suggests the stock of Converse is of higher risk than normal and that this risk is rising. The average industry ratio of 0.40 further supports this conclusion. The 2011 debt ratio for Converse is twice the industry norm. Also, a debt ratio approaching 1.0 indicates little to no equity.



## Guidance Answers to Quick Checks



- Examples of source documents are sales tickets, checks, purchase orders, charges to customers, bills from suppliers, employee earnings records, and bank statements.
- Source documents serve many purposes, including record-keeping and internal control. Source documents, especially if obtained from outside the organization, provide objective and reliable evidence about transactions and their amounts.
- |        |             |        |
|--------|-------------|--------|
| Assets | Liabilities | Equity |
| a,c,e  | b,d         | —      |
- An account is a record in an accounting system that records and stores the increases and decreases in a specific asset, liability, equity, revenue, or expense. The ledger is a collection of all the accounts of a company.
- A company's size and diversity affect the number of accounts in its accounting system. The types of accounts depend on information the company needs to both effectively operate and report its activities in financial statements.
- No. Debit and credit both can mean increase or decrease. The particular meaning in a circumstance depends on the *type of account*. For example, a debit increases the balance of asset, dividends, and expense accounts, but it decreases the balance of liability, common stock, and revenue accounts.
- A chart of accounts is a list of all of a company's accounts and their identification numbers.
- Equity is increased by revenues and by owner investments. Equity is decreased by expenses and dividends.
- The name *double-entry* is used because all transactions affect at least two accounts. There must be at least one debit in one account and at least one credit in another account.
- The answer is (c).

Cash .....	15,000	
Equipment .....	23,000	
Common Stock .....		38,000
<i>Investment by owner of cash and equipment.</i>		

- A compound journal entry affects three or more accounts.
- Posting reference numbers are entered in the journal when posting to the ledger as a cross-reference that allows the record-keeper or auditor to trace debits and credits from one record to another.
- At a minimum, dollar signs are placed beside the first and last numbers in a column. It is also common to place dollar signs beside any amount that appears after a ruled line to indicate that an addition or subtraction has occurred.
- The Equipment account balance is incorrectly reported at \$20,000—it should be \$28,000. The effect of this error understates the trial balance's Debit column total by \$8,000. This results in an \$8,000 difference between the column totals.
- An income statement reports a company's revenues and expenses along with the resulting net income or loss. A statement of retained earnings reports changes in retained earnings, including that from net income or loss. Both statements report transactions occurring over a period of time.
- The balance sheet describes a company's financial position (assets, liabilities, and equity) at a point in time. The retained earnings amount in the balance sheet is obtained from the statement of retained earnings.
- Revenues are inflows of assets in exchange for products or services provided to customers as part of the main operations of a business. Expenses are outflows or the using up of assets that result from providing products or services to customers.
- Assets are the resources a business owns or controls that carry expected future benefits. Liabilities are the obligations of a business, representing the claims of others against the assets of a business. Equity reflects the owner's claims on the assets of the business after deducting liabilities.

## Key Terms

**Account** (p. 53)

**Account balance** (p. 57)

**Balance column account** (p. 60)

**Chart of accounts** (p. 56)

**Common stock** (p. 55)

**Compound journal entry** (p. 63)

**Credit** (p. 57)

**Creditors** (p. 54)

**Debit** (p. 57)

**Debtors** (p. 53)

**Debt ratio** (p. 72)

**Dividends** (p. 55)

**Double-entry accounting** (p. 57)

**General journal** (p. 58)

**General ledger** (p. 53)

**Journal** (p. 58)

**Journalizing** (p. 58)

**Ledger** (p. 53)

**Posting** (p. 58)

**Posting reference (PR)**

**column** (p. 60)

**Source documents** (p. 52)

**T-account** (p. 57)

**Trial balance** (p. 67)

**Unearned revenue** (p. 54)



## Multiple Choice Quiz


Answers on p. 93

mhhe.com/wildFA6e







Additional quiz questions are available at the book's Website.

- Amalia Company received its utility bill for the current period of \$700 and immediately paid it. Its journal entry to record this transaction includes a
  - Credit to Utility Expense for \$700.
  - Debit to Utility Expense for \$700.
  - Debit to Accounts Payable for \$700.
  - Debit to Cash for \$700.
  - Credit to Common Stock for \$700.
- On May 1, Mattingly Lawn Service collected \$2,500 cash from a customer in advance of five months of lawn service. Mattingly's journal entry to record this transaction includes a
  - Credit to Unearned Lawn Service Fees for \$2,500.
  - Debit to Lawn Service Fees Earned for \$2,500.
  - Credit to Cash for \$2,500.
  - Debit to Unearned Lawn Service Fees for \$2,500.
  - Credit to Common Stock for \$2,500.
- Liang Shue contributed \$250,000 cash and land worth \$500,000 to open his new business, Shue Consulting Corporation. Which of the following journal entries does Shue Consulting make to record this transaction?
 

a. Cash Assets . . . . .	750,000		
Common Stock . . . . .		750,000	
b. Common Stock . . . . .	750,000		
Assets . . . . .		750,000	
c. Cash . . . . .	250,000		
Land . . . . .	500,000		
Common Stock . . . . .		750,000	
- Common Stock . . . . . 750,000  
 Cash . . . . . 250,000  
 Land . . . . . 500,000
- A trial balance prepared at year-end shows total credits exceeded total debits by \$765. This discrepancy could have been caused by
  - An error in the general journal where a \$765 increase in Accounts Payable was recorded as a \$765 decrease in Accounts Payable.
  - The ledger balance for Accounts Payable of \$7,650 being entered in the trial balance as \$765.
  - A general journal error where a \$765 increase in Accounts Receivable was recorded as a \$765 increase in Cash.
  - The ledger balance of \$850 in Accounts Receivable was entered in the trial balance as \$85.
  - An error in recording a \$765 increase in Cash as a credit.
- Bonaventure Company has total assets of \$1,000,000, liabilities of \$400,000, and equity of \$600,000. What is its debt ratio (rounded to a whole percent)?
  - 250%
  - 167%
  - 67%
  - 150%
  - 40%

 Icon denotes assignments that involve decision making.

## Discussion Questions

- Provide the names of two (a) asset accounts, (b) liability accounts, and (c) equity accounts.
- What is the difference between a note payable and an account payable?
-  Discuss the steps in processing business transactions.
- What kinds of transactions can be recorded in a general journal?
- Are debits or credits typically listed first in general journal entries? Are the debits or the credits indented?
- If assets are valuable resources and asset accounts have debit balances, why do expense accounts also have debit balances?
- Should a transaction be recorded first in a journal or the ledger? Why?
-  Why does the recordkeeper prepare a trial balance?
- If an incorrect amount is journalized and posted to the accounts, how should the error be corrected?
- Identify the four financial statements of a business.
-  What information is reported in an income statement?
-  Why does the user of an income statement need to know the time period that it covers?
-  What information is reported in a balance sheet?
- Define (a) assets, (b) liabilities, (c) equity, and (d) net assets.
- Which financial statement is sometimes called the *statement of financial position*?
-  Review the **Research In Motion** balance sheet in Appendix A. Identify three accounts on its balance sheet that carry debit balances and three accounts on its balance sheet that carry credit balances. **RIM**
- Review the **Apple** balance sheet in Appendix A. Identify an asset with the word *receivable* in its account title and a liability with the word *payable* in its account title. **Apple**
- Locate **Palm**'s income statement in Appendix A. **Palm** What is the title of its revenue account?
- Refer to **Nokia**'s balance sheet in Appendix A. **NOKIA** What does Nokia title its current asset referring to merchandise available for sale?



Identify the financial statement(s) where each of the following items appears. Use I for income statement, E for statement of retained earnings, and B for balance sheet.

- |                            |                             |                                 |
|----------------------------|-----------------------------|---------------------------------|
| <b>a.</b> Accounts payable | <b>d.</b> Office supplies   | <b>g.</b> Office equipment      |
| <b>b.</b> Cash             | <b>e.</b> Prepaid insurance | <b>h.</b> Cash dividends        |
| <b>c.</b> Rent expense     | <b>f.</b> Revenue           | <b>i.</b> Unearned rent revenue |

## QUICK STUDY

### QS 2-1

Identifying financial statement items

C2 P3

Identify the items from the following list that are likely to serve as source documents.

- |                            |                                 |                                   |
|----------------------------|---------------------------------|-----------------------------------|
| <b>a.</b> Bank statement   | <b>d.</b> Trial balance         | <b>g.</b> Company revenue account |
| <b>b.</b> Sales ticket     | <b>e.</b> Telephone bill        | <b>h.</b> Balance sheet           |
| <b>c.</b> Income statement | <b>f.</b> Invoice from supplier | <b>i.</b> Prepaid rent            |

### QS 2-2

Identifying source documents

C1

Identify whether a debit or credit yields the indicated change for each of the following accounts.

- |   |   |
|---|---|
| <b>a.</b> To increase Store Equipment   | <b>f.</b> To decrease Unearned Revenue    |
| <b>b.</b> To increase Land              | <b>g.</b> To decrease Prepaid Insurance   |
| <b>c.</b> To decrease Cash              | <b>h.</b> To increase Notes Payable       |
| <b>d.</b> To increase Utilities Expense | <b>i.</b> To decrease Accounts Receivable |
| <b>e.</b> To increase Fees Earned       | <b>j.</b> To increase Common Stock        |

### QS 2-3

Analyzing debit or credit by account

A1 

Identify the normal balance (debit or credit) for each of the following accounts.

- |                                   |                               |                             |
|-----------------------------------|-------------------------------|-----------------------------|
| <b>a.</b> Equipment               | <b>d.</b> Office Supplies     | <b>g.</b> Prepaid Insurance |
| <b>b.</b> Wages Expense           | <b>e.</b> Dividends           | <b>h.</b> Wages Payable     |
| <b>c.</b> Repair Services Revenue | <b>f.</b> Accounts Receivable | <b>i.</b> Common Stock      |

### QS 2-4

Identifying normal balance

C4

Indicate whether a debit or credit *decreases* the normal balance of each of the following accounts.

- |                               |                             |                            |
|-------------------------------|-----------------------------|----------------------------|
| <b>a.</b> Land                | <b>e.</b> Salaries Expense  | <b>i.</b> Interest Revenue |
| <b>b.</b> Service Revenue     | <b>f.</b> Common Stock      | <b>j.</b> Dividends        |
| <b>c.</b> Interest Payable    | <b>g.</b> Prepaid Insurance | <b>k.</b> Unearned Revenue |
| <b>d.</b> Accounts Receivable | <b>h.</b> Buildings         | <b>l.</b> Accounts Payable |

### QS 2-5

Linking debit or credit with normal balance

C4

Prepare journal entries for each of the following selected transactions.

- On January 15, Kolby Anderson opens a remodeling company called Fancy Kitchens by investing \$75,000 cash along with equipment having a \$30,000 value in exchange for common stock.
- On January 21, Fancy Kitchens purchases office supplies on credit for \$650.
- On January 25, Fancy Kitchens receives \$8,700 cash for performing remodeling services.
- On January 30, Fancy Kitchens receives \$4,000 cash in advance of providing remodeling services to a customer.

### QS 2-6

Preparing journal entries

P1

A trial balance has total debits of \$20,000 and total credits of \$24,500. Which one of the following errors would create this imbalance? Explain.

- A \$2,250 debit posting to Accounts Receivable was posted mistakenly to Cash.
- A \$4,500 debit posting to Equipment was posted mistakenly to Supplies.
- An entry debiting Cash and crediting Accounts Payable for \$4,500 was mistakenly not posted.
- A \$2,250 credit to Revenue in a journal entry is incorrectly posted to the ledger as a \$2,250 debit, leaving the Revenue account with a \$6,300 credit balance.
- A \$4,500 debit to Rent Expense in a journal entry is incorrectly posted to the ledger as a \$4,500 credit, leaving the Rent Expense account with a \$750 debit balance.
- A \$2,250 debit to Utilities Expense in a journal entry is incorrectly posted to the ledger as a \$2,250 credit, leaving the Utilities Expense account with a \$3,000 debit balance.

### QS 2-7

Identifying a posting error

P2 

**QS 2-8**

Classifying accounts in financial statements

P3

Indicate the financial statement on which each of the following items appears. Use I for income statement, E for statement of retained earnings, and B for balance sheet.

- |                            |                             |                               |
|----------------------------|-----------------------------|-------------------------------|
| <b>a.</b> Buildings        | <b>e.</b> Rental Revenue    | <b>i.</b> Accounts Receivable |
| <b>b.</b> Interest Expense | <b>f.</b> Insurance Expense | <b>j.</b> Salaries Expense    |
| <b>c.</b> Dividends        | <b>g.</b> Services Revenue  | <b>k.</b> Equipment           |
| <b>d.</b> Office Supplies  | <b>h.</b> Interest Payable  | <b>l.</b> Prepaid Insurance   |

**QS 2-9**

International accounting standards

C4



Answer each of the following questions related to international accounting standards.

- What type of entry system is applied when accounting follows IFRS?
- Identify the number and usual titles of the financial statements prepared under IFRS.
- How do differences in accounting controls and enforcement impact accounting reports prepared across different countries?

**EXERCISES**

Order the following steps in the accounting process that focus on analyzing and recording transactions.

**Exercise 2-1**

Steps in analyzing and recording transactions C1

- Record relevant transactions in a journal.
- Prepare and analyze the trial balance.
- Analyze each transaction from source documents.
- Post journal information to ledger accounts.

**Exercise 2-2**

Identifying and classifying accounts

C2

Enter the number for the item that best completes each of the descriptions below.

- |                   |                     |                  |
|-------------------|---------------------|------------------|
| <b>1.</b> Account | <b>3.</b> Asset     | <b>5.</b> Equity |
| <b>2.</b> Three   | <b>4.</b> Liability |                  |
- Common stock and dividends are examples of \_\_\_\_\_ accounts.
  - Accounts payable, unearned revenue, and note payable are examples of \_\_\_\_\_ accounts.
  - Accounts receivable, prepaid accounts, supplies, and land are examples of \_\_\_\_\_ accounts.
  - Accounts are arranged into \_\_\_\_\_ general categories.
  - An \_\_\_\_\_ is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item.

**Exercise 2-3**

Identifying a ledger and chart of accounts

C3

Enter the number for the item that best completes each of the descriptions below.

- |                          |                 |
|--------------------------|-----------------|
| <b>1.</b> General ledger | <b>2.</b> Chart |
|--------------------------|-----------------|
- The \_\_\_\_\_ is a record containing all accounts used by a company.
  - A \_\_\_\_\_ of accounts is a list of all accounts a company uses.

**Exercise 2-4**

Identifying type and normal balances of accounts

C4

For each of the following (1) identify the type of account as an asset, liability, equity, revenue, or expense, (2) identify the normal balance of the account, and (3) enter *debit (Dr.)* or *credit (Cr.)* to identify the kind of entry that would increase the account balance.

- |                         |                             |                               |
|-------------------------|-----------------------------|-------------------------------|
| <b>a.</b> Fees Earned   | <b>e.</b> Cash              | <b>i.</b> Accounts Receivable |
| <b>b.</b> Equipment     | <b>f.</b> Legal Expense     | <b>j.</b> Dividends           |
| <b>c.</b> Notes Payable | <b>g.</b> Prepaid Insurance | <b>k.</b> License Fee Revenue |
| <b>d.</b> Common Stock  | <b>h.</b> Land              | <b>l.</b> Unearned Revenue    |

**Exercise 2-5**

Analyzing effects of transactions on accounts

A1



Taylor Co. bills a client \$48,000 for services provided and agrees to accept the following three items in full payment: (1) \$7,500 cash, (2) computer equipment worth \$75,000, and (3) to assume responsibility for a \$34,500 note payable related to the computer equipment. The entry Taylor makes to record this transaction includes which one or more of the following?

- |  |  |
|--|--|
| <b>a.</b> \$34,500 increase in a liability account | <b>d.</b> \$48,000 increase in an asset account  |
| <b>b.</b> \$7,500 increase in the Cash account     | <b>e.</b> \$48,000 increase in a revenue account |
| <b>c.</b> \$7,500 increase in a revenue account    | <b>f.</b> \$34,500 increase in an equity account |



Use the information in each of the following separate cases to calculate the unknown amount.

- a. During October, Shandra Company had \$97,500 of cash receipts and \$101,250 of cash disbursements. The October 31 Cash balance was \$16,800. Determine how much cash the company had at the close of business on September 30.
- b. On September 30, Mordish Co. had a \$97,500 balance in Accounts Receivable. During October, the company collected \$88,950 from its credit customers. The October 31 balance in Accounts Receivable was \$100,500. Determine the amount of sales on account that occurred in October.
- c. Nasser Co. had \$147,000 of accounts payable on September 30 and \$136,500 on October 31. Total purchases on account during October were \$270,000. Determine how much cash was paid on accounts payable during October.

**Exercise 2-6**

Analyzing account entries and balances



Prepare general journal entries for the following transactions of a new company called Pose for Pics.

- Aug. 1 Kasey Madison, the owner, invested \$7,500 cash and \$32,500 of photography equipment in the company in exchange for common stock.
- 2 The company paid \$3,000 cash for an insurance policy covering the next 24 months.
- 5 The company purchased office supplies for \$1,400 cash.
- 20 The company received \$2,650 cash in photography fees earned.
- 31 The company paid \$875 cash for August utilities.

**Exercise 2-7**

Preparing general journal entries

P1

Use the information in Exercise 2-7 to prepare an August 31 trial balance for Pose for Pics. Begin by opening these T-accounts: Cash; Office Supplies; Prepaid Insurance; Photography Equipment; Common Stock; Photography Fees Earned; and Utilities Expense. Then, post the general journal entries to these T-accounts (which will serve as the ledger), and prepare the trial balance.

**Exercise 2-8**

Preparing T-accounts (ledger) and a trial balance P2

Prepare general journal entries to record the transactions below for Dexter Company by using the following accounts: Cash; Accounts Receivable; Office Supplies; Office Equipment; Accounts Payable; Common Stock; Dividends; Fees Earned; and Rent Expense. Use the letters beside each transaction to identify entries. After recording the transactions, post them to T-accounts, which serves as the general ledger for this assignment. Determine the ending balance of each T-account.

- a. Macy Dexter, owner, invested \$12,750 cash in the company in exchange for common stock.
- b. The company purchased office supplies for \$375 cash.
- c. The company purchased \$7,050 of office equipment on credit.
- d. The company received \$1,500 cash as fees for services provided to a customer.
- e. The company paid \$7,050 cash to settle the payable for the office equipment purchased in transaction c.
- f. The company billed a customer \$2,700 as fees for services provided.
- g. The company paid \$525 cash for the monthly rent.
- h. The company collected \$1,125 cash as partial payment for the account receivable created in transaction f.
- i. The company paid \$1,000 cash for dividends.

**Exercise 2-9**

Recording effects of transactions in T-accounts

A1

**Check** Cash ending balance, \$6,425

After recording the transactions of Exercise 2-9 in T-accounts and calculating the balance of each account, prepare a trial balance. Use May 31, 2011, as its report date.

**Exercise 2-10**

Preparing a trial balance P2

Examine the following transactions and identify those that create revenues for Jade Services, a company owned by Mia Jade. Prepare general journal entries to record those revenue transactions and explain why the other transactions did not create revenues.

- a. Mia Jade invests \$38,250 cash in the company in exchange for common stock.
- b. The company provided \$1,350 of services on credit.
- c. The company provided services to a client and immediately received \$1,575 cash.
- d. The company received \$9,150 cash from a client in payment for services to be provided next year.
- e. The company received \$4,500 cash from a client in partial payment of an account receivable.
- f. The company borrowed \$150,000 cash from the bank by signing a promissory note.

**Exercise 2-11**

Analyzing and journalizing revenue transactions





**Exercise 2-12**

Analyzing and journalizing expense transactions



Examine the following transactions and identify those that create expenses for Jade Services. Prepare general journal entries to record those expense transactions and explain why the other transactions did not create expenses.

- a. The company paid \$14,100 cash for payment on a 14-month old liability for office supplies.
- b. The company paid \$1,125 cash for the just completed two-week salary of the receptionist.
- c. The company paid \$45,000 cash for equipment purchased.
- d. The company paid \$930 cash for this month's utilities.
- e. The company paid \$5,000 cash for dividends.

**Exercise 2-13**

Preparing an income statement



Dominick Lopez operates a consulting firm called Tech Today, which began operations on August 1. On August 31, the company's records show the following accounts and amounts for the month of August. Use this information to prepare an August income statement for the business.

Cash .....	\$ 8,360	Dividends .....	\$ 3,000
Accounts receivable .....	17,000	Consulting fees earned .....	17,000
Office supplies .....	3,250	Rent expense .....	4,550
Land .....	46,000	Salaries expense .....	8,000
Office equipment .....	18,000	Telephone expense .....	560
Accounts payable .....	8,000	Miscellaneous expenses .....	280
Common Stock .....	84,000		

**Check** Net income, \$3,610

**Exercise 2-14**

Preparing a statement of retained earnings P3

**Check** End. Ret. Earn., \$610

Use the information in Exercise 2-13 to prepare an August statement of retained earnings for Tech Today. (The owner invested \$84,000 cash in the company in exchange for common stock on August 1.)

**Exercise 2-15**

Preparing a balance sheet P3

Use the information in Exercise 2-13 (if completed, you can also use your solution to Exercise 2-14) to prepare an August 31 balance sheet for Tech Today.

**Exercise 2-16**

Computing net income



A corporation had the following assets and liabilities at the beginning and end of this year.

	Assets	Liabilities
Beginning of the year .....	\$ 70,000	\$30,000
End of the year .....	115,000	46,000

Determine the net income earned or net loss incurred by the business during the year for each of the following *separate* cases:

- a. Owner made no investments in the business and no dividends were paid during the year.
- b. Owner made no investments in the business, but dividends were \$1,250 cash per month.
- c. No dividends were paid during the year, but the owner did invest an additional \$45,000 cash in exchange for common stock.
- d. Dividends were \$1,250 cash per month and the owner invested an additional \$25,000 cash in exchange for common stock.

**Exercise 2-17**

Analyzing changes in a company's equity



Compute the missing amount for each of the following separate companies *a* through *d*.

	(a)	(b)	(c)	(d)
Equity, December 31, 2010	\$ 0	\$ 0	\$ 0	\$ 0
Owner investments during the year	120,000	?	87,000	210,000
Dividends during the year	?	54,000	10,000	55,000
Net income (loss) for the year	31,500	81,000	(4,000)	?
Equity, December 31, 2011	102,000	99,000	?	110,000



Assume the following T-accounts reflect Joy Co.'s general ledger and that seven transactions *a* through *g* are posted to them. Provide a short description of each transaction. Include the amounts in your descriptions.

Cash			
(a)	7,000	(b)	3,600
(e)	2,500	(c)	600
		(f)	2,400
		(g)	700

Office Supplies	
(c)	600
(d)	200

Prepaid Insurance	
(b)	3,600

Equipment	
(a)	5,600
(d)	9,400

Automobiles	
(a)	11,000

Accounts Payable	
(f)	2,400
(d)	9,600

Common Stock	
(a)	23,600

Delivery Services Revenue	
(e)	2,500

Gas and Oil Expense	
(g)	700

**Exercise 2-18**

Interpreting and describing transactions from T-accounts

A1



Use information from the T-accounts in Exercise 2-18 to prepare general journal entries for each of the seven transactions *a* through *g*.

**Exercise 2-19**

Preparing general journal entries

P1

Posting errors are identified in the following table. In column (1), enter the amount of the difference between the two trial balance columns (debit and credit) due to the error. In column (2), identify the trial balance column (debit or credit) with the larger amount if they are not equal. In column (3), identify the account(s) affected by the error. In column (4), indicate the amount by which the account(s) in column (3) is under- or overstated. Item (a) is completed as an example.

**Exercise 2-20**

Identifying effects of posting errors on the trial balance

A1 P2

	Description of Posting Error	(1) Difference between Debit and Credit Columns	(2) Column with the Larger Total	(3) Identify Account(s) Incorrectly Stated	(4) Amount that Account(s) Is Over- or Understated
a.	\$2,400 debit to Rent Expense is posted as a \$1,590 debit.	\$810	Credit	Rent Expense	Rent Expense understated \$810
b.	\$4,050 credit to Cash is posted twice as two credits to Cash.				
c.	\$9,900 debit to the Dividends account is debited to Common Stock.				
d.	\$2,250 debit to Prepaid Insurance is posted as a debit to Insurance Expense.				
e.	\$42,000 debit to Machinery is posted as a debit to Accounts Payable.				
f.	\$4,950 credit to Services Revenue is posted as a \$495 credit.				
g.	\$1,440 debit to Store Supplies is not posted.				

You are told the column totals in a trial balance are not equal. After careful analysis, you discover only one error. Specifically, a correctly journalized credit purchase of a computer for \$16,950 is posted from the journal to the ledger with a \$16,950 debit to Office Equipment and another \$16,950 debit to Accounts Payable. The Office Equipment account has a debit balance of \$40,100 on the trial balance. Answer each of the following questions and compute the dollar amount of any misstatement.

**Exercise 2-21**

Analyzing a trial balance error

A1 P2



- a. Is the debit column total of the trial balance overstated, understated, or correctly stated?
- b. Is the credit column total of the trial balance overstated, understated, or correctly stated?
- c. Is the Office Equipment account balance overstated, understated, or correctly stated in the trial balance?
- d. Is the Accounts Payable account balance overstated, understated, or correctly stated in the trial balance?
- e. If the debit column total of the trial balance is \$360,000 before correcting the error, what is the total of the credit column before correction?

**Exercise 2-22**

Interpreting the debt ratio and return on assets



- a. Calculate the debt ratio and the return on assets using the year-end information for each of the following six separate companies (\$ thousands).

Case	Assets	Liabilities	Average Assets	Net Income
Company 1	\$147,000	\$56,000	\$200,000	\$21,000
Company 2	104,500	51,500	70,000	12,000
Company 3	90,500	12,000	100,000	20,000
Company 4	92,000	31,000	40,000	7,500
Company 5	64,000	47,000	40,000	3,800
Company 6	32,500	26,500	50,000	660

- b. Of the six companies, which business relies most heavily on creditor financing?
- c. Of the six companies, which business relies most heavily on equity financing?
- d. Which two companies indicate the greatest risk?
- e. Which two companies earn the highest return on assets?
- f. Which one company would investors likely prefer based on the risk–return relation?

**Exercise 2-23**

Preparing a balance sheet following IFRS



**BMW** reports the following balance sheet accounts for the year ended December 31, 2009 (euro in millions). Prepare the balance sheet for this company as of December 31, 2009, following the usual IFRS formats.

Current liabilities	€ 8,350	Noncurrent liabilities	€10,943
Current assets	17,663	Noncurrent assets	6,984
Total equity	5,354		



**PROBLEM SET A**

**Problem 2-1A**

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2



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Gary Bauer opens a computer consulting business called Technology Consultants and completes the following transactions in April.

- April 1 Bauer invested \$100,000 cash along with \$24,000 in office equipment in the company in exchange for common stock.
- 2 The company prepaid \$7,200 cash for twelve months' rent for an office. (*Hint: Debit Prepaid Rent for \$7,200.*)
- 3 The company made credit purchases of office equipment for \$12,000 and office supplies for \$2,400. Payment is due within 10 days.
- 6 The company completed services for a client and immediately received \$2,000 cash.
- 9 The company completed an \$8,000 project for a client, who must pay within 30 days.
- 13 The company paid \$14,400 cash to settle the account payable created on April 3.
- 19 The company paid \$6,000 cash for the premium on a 12-month insurance policy. (*Hint: Debit Prepaid Insurance for \$6,000.*)
- 22 The company received \$6,400 cash as partial payment for the work completed on April 9.
- 25 The company completed work for another client for \$2,640 on credit.
- 28 The company paid \$6,200 cash for dividends.
- 29 The company purchased \$800 of additional office supplies on credit.
- 30 The company paid \$700 cash for this month's utility bill.

**Required**

- 1. Prepare general journal entries to record these transactions (use the account titles listed in part 2).
- 2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (124); Prepaid Insurance (128);



Prepaid Rent (131); Office Equipment (163); Accounts Payable (201); Common Stock (307); Dividends (319); Services Revenue (403); and Utilities Expense (690). Post the journal entries from part 1 to the ledger accounts and enter the balance after each posting.

3. Prepare a trial balance as of the end of April.

**Check** (2) Ending balances: Cash, \$73,900; Accounts Receivable, \$4,240; Accounts Payable, \$800  
(3) Total debits, \$137,440

Shelton Engineering completed the following transactions in the month of June.

- a. Shana Shelton, the owner, invested \$105,000 cash, office equipment with a value of \$6,000, and \$45,000 of drafting equipment to launch the company in exchange for common stock.
- b. The company purchased land worth \$54,000 for an office by paying \$5,400 cash and signing a long-term note payable for \$48,600.
- c. The company purchased a portable building with \$75,000 cash and moved it onto the land acquired in *b*.
- d. The company paid \$6,000 cash for the premium on an 18-month insurance policy.
- e. The company completed and delivered a set of plans for a client and collected \$5,700 cash.
- f. The company purchased \$22,500 of additional drafting equipment by paying \$10,500 cash and signing a long-term note payable for \$12,000.
- g. The company completed \$12,000 of engineering services for a client. This amount is to be received in 30 days.
- h. The company purchased \$2,250 of additional office equipment on credit.
- i. The company completed engineering services for \$18,000 on credit.
- j. The company received a bill for rent of equipment that was used on a recently completed job. The \$1,200 rent cost must be paid within 30 days.
- k. The company collected \$7,200 cash in partial payment from the client described in transaction *g*.
- l. The company paid \$1,500 cash for wages to a drafting assistant.
- m. The company paid \$2,250 cash to settle the account payable created in transaction *h*.
- n. The company paid \$675 cash for minor maintenance of its drafting equipment.
- o. The company paid \$9,360 cash for dividends.
- p. The company paid \$1,500 cash for wages to a drafting assistant.
- q. The company paid \$3,000 cash for advertisements in the local newspaper during June.

**Problem 2-2A**

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2

**Required**

1. Prepare general journal entries to record these transactions (use the account titles listed in part 2).
2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Prepaid Insurance (108); Office Equipment (163); Drafting Equipment (164); Building (170); Land (172); Accounts Payable (201); Notes Payable (250); Common Stock (307); Dividends (319); Engineering Fees Earned (402); Wages Expense (601); Equipment Rental Expense (602); Advertising Expense (603); and Repairs Expense (604). Post the journal entries from part 1 to the accounts and enter the balance after each posting.
3. Prepare a trial balance as of the end of June.

**Check** (2) Ending balances: Cash, \$2,715; Accounts Receivable, \$22,800; Accounts Payable, \$1,200

(3) Trial balance totals, \$253,500

The accounting records of Fabiano Distribution show the following assets and liabilities as of December 31, 2010 and 2011.

December 31	2010	2011
Cash .....	\$ 52,500	\$ 18,750
Accounts receivable .....	28,500	22,350
Office supplies .....	4,500	3,300
Office equipment .....	138,000	147,000
Trucks .....	54,000	54,000
Building .....	0	180,000
Land .....	0	45,000
Accounts payable .....	7,500	37,500
Note payable .....	0	105,000

Late in December 2011, the business purchased a small office building and land for \$225,000. It paid \$120,000 cash toward the purchase and a \$105,000 note payable was signed for the balance. Mr. Fabiano had to invest \$35,000 cash in the business (in exchange for stock) to enable it to pay the \$120,000 cash. The business also pays \$3,000 cash per month for dividends.

**Problem 2-3A**

Computing net income from equity analysis, preparing a balance sheet, and computing the debt ratio

C2 A1 A2 P3



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**Required**

1. Prepare balance sheets for the business as of December 31, 2010 and 2011. (*Hint:* Report only total equity on the balance sheet and remember that total equity equals the difference between assets and liabilities.)
2. By comparing equity amounts from the balance sheets and using the additional information presented in this problem, prepare a calculation to show how much net income was earned by the business during 2011.
3. Compute the 2011 year-end debt ratio for the business.

**Check** (2) Net income, \$58,900

(3) Debt ratio, 30.29%

**Problem 2-4A**

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2

Santo Birch opens a Web consulting business called Show-Me-the-Money and completes the following transactions in its first month of operations.

- March 1 Birch invests \$150,000 cash along with office equipment valued at \$22,000 in the company in exchange for common stock.
- 2 The company prepaid \$6,000 cash for twelve months' rent for office space. (*Hint:* Debit Prepaid Rent for \$6,000.)
- 3 The company made credit purchases for \$3,000 in office equipment and \$1,200 in office supplies. Payment is due within 10 days.
- 6 The company completed services for a client and immediately received \$4,000 cash.
- 9 The company completed a \$7,500 project for a client, who must pay within 30 days.
- 13 The company paid \$4,200 cash to settle the account payable created on March 3.
- 19 The company paid \$5,000 cash for the premium on a 12-month insurance policy. (*Hint:* Debit Prepaid Insurance for \$5,000.)
- 22 The company received \$3,500 cash as partial payment for the work completed on March 9.
- 25 The company completed work for another client for \$3,820 on credit.
- 29 The company paid \$5,100 cash for dividends.
- 30 The company purchased \$600 of additional office supplies on credit.
- 31 The company paid \$200 cash for this month's utility bill.

**Required**

1. Prepare general journal entries to record these transactions (use account titles listed in part 2).
2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (124); Prepaid Insurance (128); Prepaid Rent (131); Office Equipment (163); Accounts Payable (201); Common Stock (307); Dividends (319); Services Revenue (403); and Utilities Expense (690). Post journal entries from part 1 to the ledger accounts and enter the balance after each posting.
3. Prepare a trial balance as of March 31.

**Check** (2) Ending balances: Cash, \$137,000; Accounts Receivable, \$7,820; Accounts Payable, \$600

(3) Total debits, \$187,920

**Problem 2-5A**

Recording transactions; posting to ledger; preparing a trial balance

C3 A1 P1 P2

Business transactions completed by Eric Pense during the month of September are as follows.

- a. Pense invested \$23,000 cash along with office equipment valued at \$12,000 in exchange for common stock of a new company named EP Consulting.
- b. The company purchased land valued at \$8,000 and a building valued at \$33,000. The purchase is paid with \$15,000 cash and a long-term note payable for \$26,000.
- c. The company purchased \$600 of office supplies on credit.
- d. Pense invested his personal automobile in the company in exchange for more common stock. The automobile has a value of \$7,000 and is to be used exclusively in the business.
- e. The company purchased \$1,100 of additional office equipment on credit.
- f. The company paid \$800 cash salary to an assistant.
- g. The company provided services to a client and collected \$2,700 cash.
- h. The company paid \$430 cash for this month's utilities.
  - i. The company paid \$600 cash to settle the account payable created in transaction c.
  - j. The company purchased \$4,000 of new office equipment by paying \$4,000 cash.
  - k. The company completed \$2,400 of services for a client, who must pay within 30 days.
    - l. The company paid \$800 cash salary to an assistant.
- m. The company received \$1,000 cash in partial payment on the receivable created in transaction k.
- n. The company paid \$1,050 cash for dividends.

**Required**

1. Prepare general journal entries to record these transactions (use account titles listed in part 2).
2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (108); Office Equipment (163); Automobiles (164); Building (170); Land (172); Accounts Payable (201); Notes Payable (250); Common Stock (307); Dividends (319); Fees Earned (402); Salaries Expense (601); and Utilities Expense (602). Post the journal entries from part 1 to the ledger accounts and enter the balance after each posting.
3. Prepare a trial balance as of the end of September.

**Check** (2) Ending balances: Cash, \$4,020; Office Equipment, \$17,100

(3) Trial balance totals, \$74,200

Carlos Beltran started an engineering firm called Beltran Engineering. He began operations and completed seven transactions in May, which included his initial investment of \$17,000 cash. After those seven transactions, the ledger included the following accounts with normal balances.

Cash .....	\$26,660
Office supplies .....	660
Prepaid insurance .....	3,200
Office equipment .....	16,500
Accounts payable .....	16,500
Common Stock .....	17,000
Dividends .....	3,740
Engineering fees earned .....	24,000
Rent expense .....	6,740

**Problem 2-6A**

Analyzing account balances and reconstructing transactions

C1 C3 A1 P2 

**Required**

1. Prepare a trial balance for this business as of the end of May.

**Check** (1) Trial balance totals, \$57,500

**Analysis Components**

2. Analyze the accounts and their balances and prepare a list that describes each of the seven most likely transactions and their amounts.
3. Prepare a report of cash received and cash paid showing how the seven transactions in part 2 yield the \$26,660 ending Cash balance.

(3) Cash paid, \$14,340

Shaw Management Services opens for business and completes these transactions in November.

- Nov. 1 Kita Shaw, the owner, invested \$30,000 cash along with \$15,000 of office equipment in the company in exchange for common stock.
- 2 The company prepaid \$4,500 cash for six months' rent for an office. (*Hint*: Debit Prepaid Rent for \$4,500.)
- 4 The company made credit purchases of office equipment for \$2,500 and of office supplies for \$600. Payment is due within 10 days.
- 8 The company completed work for a client and immediately received \$3,400 cash.
- 12 The company completed a \$10,200 project for a client, who must pay within 30 days.
- 13 The company paid \$3,100 cash to settle the payable created on November 4.
- 19 The company paid \$1,800 cash for the premium on a 24-month insurance policy.
- 22 The company received \$5,200 cash as partial payment for the work completed on November 12.
- 24 The company completed work for another client for \$1,750 on credit.
- 28 The company paid \$5,300 cash for dividends.
- 29 The company purchased \$249 of additional office supplies on credit.
- 30 The company paid \$531 cash for this month's utility bill.

**PROBLEM SET B****Problem 2-1B**

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2

**Required**

1. Prepare general journal entries to record these transactions (use account titles listed in part 2).
2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (124); Prepaid Insurance (128); Prepaid Rent (131); Office Equipment (163); Accounts Payable (201); Common Stock (307); Dividends (319); Services Revenue (403); and Utilities Expense (690). Post the journal entries from part 1 to the ledger accounts and enter the balance after each posting.
3. Prepare a trial balance as of the end of November.

**Check** (2) Ending balances: Cash, \$23,369; Accounts Receivable, \$6,750; Accounts Payable, \$249

(3) Total debits, \$60,599

**Problem 2-2B**

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2

At the beginning of April, Brooke Gable launched a custom computer solutions company called Softways. The company had the following transactions during April.

- a. Brooke Gable invested \$45,000 cash, office equipment with a value of \$4,500, and \$28,000 of computer equipment in the company in exchange for common stock.
- b. The company purchased land worth \$24,000 for an office by paying \$4,800 cash and signing a long-term note payable for \$19,200.
- c. The company purchased a portable building with \$21,000 cash and moved it onto the land acquired in *b*.
- d. The company paid \$6,600 cash for the premium on a two-year insurance policy.
- e. The company provided services to a client and immediately collected \$3,200 cash.
- f. The company purchased \$3,500 of additional computer equipment by paying \$700 cash and signing a long-term note payable for \$2,800.
- g. The company completed \$3,750 of services for a client. This amount is to be received within 30 days.
- h. The company purchased \$750 of additional office equipment on credit.
- i. The company completed client services for \$9,200 on credit.
- j. The company received a bill for rent of a computer testing device that was used on a recently completed job. The \$320 rent cost must be paid within 30 days.
- k. The company collected \$4,600 cash in partial payment from the client described in transaction *i*.
- l. The company paid \$1,600 cash for wages to an assistant.
- m. The company paid \$750 cash to settle the payable created in transaction *h*.
- n. The company paid \$425 cash for minor maintenance of the company's computer equipment.
- o. The company paid \$3,875 cash for dividends.
- p. The company paid \$1,600 cash for wages to an assistant.
- q. The company paid \$800 cash for advertisements in the local newspaper during April.

**Required**

1. Prepare general journal entries to record these transactions (use account titles listed in part 2).
2. Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Prepaid Insurance (108); Office Equipment (163); Computer Equipment (164); Building (170); Land (172); Accounts Payable (201); Notes Payable (250); Common Stock (307); Dividends (319); Fees Earned (402); Wages Expense (601); Computer Rental Expense (602); Advertising Expense (603); and Repairs Expense (604). Post the journal entries from part 1 to the accounts and enter the balance after each posting.
3. Prepare a trial balance as of the end of April.

**Check** (2) Ending balances: Cash, \$10,650; Accounts Receivable, \$8,350; Accounts Payable, \$320

(3) Trial balance totals, \$115,970

**Problem 2-3B**

Computing net income from equity analysis, preparing a balance sheet, and computing the debt ratio

C2 A1 A2 P3



The accounting records of Schmit Co. show the following assets and liabilities as of December 31, 2010 and 2011.

December 31	2010	2011
Cash .....	\$14,000	\$ 10,000
Accounts receivable .....	25,000	30,000
Office supplies .....	10,000	12,500
Office equipment .....	60,000	60,000
Machinery .....	30,500	30,500
Building .....	0	260,000
Land .....	0	65,000
Accounts payable .....	5,000	15,000
Note payable .....	0	260,000

Late in December 2011, the business purchased a small office building and land for \$325,000. It paid \$65,000 cash toward the purchase and a \$260,000 note payable was signed for the balance. Janet Schmit, the owner, had to invest an additional \$25,000 cash (in exchange for common stock) to enable it to pay the \$65,000 cash toward the purchase. The company also pays \$1,000 cash per month for dividends.

**Required**

1. Prepare balance sheets for the business as of December 31, 2010 and 2011. (*Hint:* Report only total equity on the balance sheet and remember that total equity equals the difference between assets and liabilities.)



- By comparing equity amounts from the balance sheets and using the additional information presented in the problem, prepare a calculation to show how much net income was earned by the business during 2011.
- Calculate the December 31, 2011, debt ratio for the business.

**Check** (2) Net income, \$45,500

(3) Debt ratio, 58.76%

Lummus Management Services opens for business and completes these transactions in September.

- Sept. 1 Rhonda Lummus, the owner, invests \$28,000 cash along with office equipment valued at \$25,000 in the company in exchange for common stock.
- 2 The company prepaid \$10,500 cash for 12 months' rent for office space. (*Hint:* Debit Prepaid Rent for \$10,500.)
- 4 The company made credit purchases for \$9,000 in office equipment and \$1,200 in office supplies. Payment is due within 10 days.
- 8 The company completed work for a client and immediately received \$2,600 cash.
- 12 The company completed a \$13,400 project for a client, who must pay within 30 days.
- 13 The company paid \$10,200 cash to settle the payable created on September 4.
- 19 The company paid \$5,200 cash for the premium on an 18-month insurance policy. (*Hint:* Debit Prepaid Insurance for \$5,200.)
- 22 The company received \$7,800 cash as partial payment for the work completed on September 12.
- 24 The company completed work for another client for \$1,900 on credit.
- 28 The company paid \$5,300 cash for dividends.
- 29 The company purchased \$1,700 of additional office supplies on credit.
- 30 The company paid \$460 cash for this month's utility bill.

### Problem 2-4B

Preparing and posting journal entries; preparing a trial balance

C3 C4 A1 P1 P2

### Required

- Prepare general journal entries to record these transactions (use account titles listed in part 2).
- Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (124); Prepaid Insurance (128); Prepaid Rent (131); Office Equipment (163); Accounts Payable (201); Common Stock (307); Dividends (319); Service Fees Earned (401); and Utilities Expense (690). Post journal entries from part 1 to the ledger accounts and enter the balance after each posting.
- Prepare a trial balance as of the end of September.

**Check** (2) Ending balances: Cash, \$6,740; Accounts Receivable, \$7,500; Accounts Payable, \$1,700

(3) Total debits, \$72,600

Cooke Consulting completed the following transactions during June.

- Chris Cooke, the owner, invested \$80,000 cash along with office equipment valued at \$30,000 in the new company in exchange for common stock.
- The company purchased land valued at \$30,000 and a building valued at \$170,000. The purchase is paid with \$40,000 cash and a long-term note payable for \$160,000.
- The company purchased \$2,400 of office supplies on credit.
- C. Cooke invested his personal automobile in the company in exchange for more common stock. The automobile has a value of \$18,000 and is to be used exclusively in the business.
- The company purchased \$6,000 of additional office equipment on credit.
- The company paid \$1,500 cash salary to an assistant.
- The company provided services to a client and collected \$6,000 cash.
- The company paid \$800 cash for this month's utilities.
  - The company paid \$2,400 cash to settle the payable created in transaction *c*.
  - The company purchased \$20,000 of new office equipment by paying \$20,000 cash.
- The company completed \$5,200 of services for a client, who must pay within 30 days.
  - The company paid \$1,500 cash salary to an assistant.
- The company received \$3,800 cash in partial payment on the receivable created in transaction *k*.
- The company paid \$6,400 cash for dividends.

### Problem 2-5B

Recording transactions; posting to ledger; preparing a trial balance

C3 A1 P1 P2

### Required

- Prepare general journal entries to record these transactions (use account titles listed in part 2).
- Open the following ledger accounts—their account numbers are in parentheses (use the balance column format): Cash (101); Accounts Receivable (106); Office Supplies (108); Office Equipment (163); Automobiles (164); Building (170); Land (172); Accounts Payable (201); Notes Payable (250); Common Stock (307); Dividends (319); Fees Earned (402); Salaries Expense (601); and Utilities Expense (602). Post the journal entries from part 1 to the ledger accounts and enter the balance after each posting.
- Prepare a trial balance as of the end of June.

**Check** (2) Ending balances: Cash, \$17,200; Office Equipment, \$56,000

(3) Trial balance totals, \$305,200



**Problem 2-6B**

Analyzing account balances and reconstructing transactions



Michael Gould started a Web consulting firm called Gould Solutions. He began operations and completed seven transactions in April that resulted in the following accounts, which all have normal balances.

Cash .....	\$12,485
Office supplies .....	560
Prepaid rent .....	1,500
Office equipment .....	11,450
Accounts payable .....	11,450
Common Stock .....	10,000
Dividends .....	6,200
Consulting fees earned .....	16,400
Operating expenses .....	5,655

**Required**

**Check** (1) Trial balance total, \$37,850

1. Prepare a trial balance for this business as of the end of April.

**Analysis Component**

(3) Cash paid, \$13,915

2. Analyze the accounts and their balances and prepare a list that describes each of the seven most likely transactions and their amounts.
3. Prepare a report of cash received and cash paid showing how the seven transactions in part 2 yield the \$12,485 ending Cash balance.

**SERIAL PROBLEM**

Business Solutions



(This serial problem started in Chapter 1 and continues through most of the chapters. If the Chapter 1 segment was not completed, the problem can begin at this point. It is helpful, but not necessary, to use the Working Papers that accompany this book.)

**SP 2** On October 1, 2011, Santana Rey launched a computer services company called **Business Solutions**, which provides consulting services, computer system installations, and custom program development. Rey adopts the calendar year for reporting purposes and expects to prepare the company's first set of financial statements on December 31, 2011. The company's initial chart of accounts follows.

Account	No.	Account	No.
Cash .....	101	Common Stock .....	307
Accounts Receivable .....	106	Dividends .....	319
Computer Supplies .....	126	Computer Services Revenue .....	403
Prepaid Insurance .....	128	Wages Expense .....	623
Prepaid Rent .....	131	Advertising Expense .....	655
Office Equipment .....	163	Mileage Expense .....	676
Computer Equipment .....	167	Miscellaneous Expenses .....	677
Accounts Payable .....	201	Repairs Expense—Computer .....	684

**Required**

1. Prepare journal entries to record each of the following transactions for Business Solutions.
  - Oct. 1 S. Rey invested \$45,000 cash, a \$20,000 computer system, and \$8,000 of office equipment in the company in exchange for its common stock.
  - 2 The company paid \$3,300 cash for four months' rent. (*Hint:* Debit Prepaid Rent for \$3,300.)
  - 3 The company purchased \$1,420 of computer supplies on credit from Harris Office Products.
  - 5 The company paid \$2,220 cash for one year's premium on a property and liability insurance policy. (*Hint:* Debit Prepaid Insurance for \$2,220.)
  - 6 The company billed Easy Leasing \$4,800 for services performed in installing a new Web server.
  - 8 The company paid \$1,420 cash for the computer supplies purchased from Harris Office Products on October 3.
  - 10 The company hired Lyn Addie as a part-time assistant for \$125 per day, as needed.
  - 12 The company billed Easy Leasing another \$1,400 for services performed.



- 15 The company received \$4,800 cash from Easy Leasing as partial payment on its account.
  - 17 The company paid \$805 cash to repair computer equipment that was damaged when moving it.
  - 20 The company paid \$1,728 cash for advertisements published in the local newspaper.
  - 22 The company received \$1,400 cash from Easy Leasing on its account.
  - 28 The company billed IFM Company \$5,208 for services performed.
  - 31 The company paid \$875 cash for Lyn Addie’s wages for seven days’ work.
  - 31 The company paid \$3,600 cash for dividends.
  - Nov. 1 The company reimbursed S. Rey in cash for business automobile mileage allowance (Rey logged 1,000 miles at \$0.32 per mile).
  - 2 The company received \$4,633 cash from Liu Corporation for computer services performed.
  - 5 The company purchased computer supplies for \$1,125 cash from Harris Office Products.
  - 8 The company billed Gomez Co. \$5,668 for services performed.
  - 13 The company received notification from Alex’s Engineering Co. that Business Solutions’ bid of \$3,950 for an upcoming project is accepted.
  - 18 The company received \$2,208 cash from IFM Company as partial payment of the October 28 bill.
  - 22 The company donated \$250 cash to the United Way in the company’s name.
  - 24 The company completed work for Alex’s Engineering Co. and sent it a bill for \$3,950.
  - 25 The company sent another bill to IFM Company for the past-due amount of \$3,000.
  - 28 The company reimbursed S. Rey in cash for business automobile mileage (1,200 miles at \$0.32 per mile).
  - 30 The company paid \$1,750 cash for Lyn Addie’s wages for 14 days’ work.
  - 30 The company paid \$2,000 cash for dividends.
2. Open ledger accounts (in balance column format) and post the journal entries from part 1 to them.
3. Prepare a trial balance as of the end of November.

**Check** (2) Cash, Nov. 30 bal., \$38,264  
 (3) Trial bal. totals, \$98,659

**Beyond the Numbers**

**BTN 2-1** Refer to **Research In Motion’s** financial statements in Appendix A for the following questions.

**Required**

1. What amount of total liabilities does it report for each of the fiscal years ended February 28, 2009, and February 27, 2010?
2. What amount of total assets does it report for each of the fiscal years ended February 28, 2009, and February 27, 2010?
3. Compute its debt ratio for each of the fiscal years ended February 28, 2009, and February 27, 2010.
4. In which fiscal year did it employ more financial leverage (February 28, 2009, or February 27, 2010)? Explain.

**Fast Forward**

5. Access its financial statements (10-K report) for a fiscal year ending after February 27, 2010, from its Website (**RIM.com**) or the SEC’s EDGAR database (**www.sec.gov**). Recompute its debt ratio for any subsequent year’s data and compare it with the debt ratio for 2009 and 2010.

**REPORTING IN ACTION**

A1 A2

**RIM**

**BTN 2-2** Key comparative figures for **Research In Motion** and **Apple** follow.

(\$ millions)	Research In Motion		Apple	
	Current Year	Prior Year	Current Year	Prior Year
Total liabilities . . . . .	\$ 2,602	\$ 2,227	\$15,861	\$13,874
Total assets . . . . .	10,204	8,101	47,501	36,171

**COMPARATIVE ANALYSIS**

A1 A2

**RIM**

**Apple**

1. What is the debt ratio for Research In Motion in the current year and for the prior year?
2. What is the debt ratio for Apple in the current year and for the prior year?
3. Which of the two companies has the higher degree of financial leverage? What does this imply?



## ETHICS CHALLENGE

C1



**BTN 2-3** Review the *Decision Ethics* case from the first part of this chapter involving the cashier. The guidance answer suggests that you should not comply with the assistant manager's request.

### Required

Propose and evaluate two other courses of action you might consider, and explain why.

## COMMUNICATING IN PRACTICE

C1 C2 A1 P3



**BTN 2-4** Mora Stanley is an aspiring entrepreneur and your friend. She is having difficulty understanding the purposes of financial statements and how they fit together across time.

### Required

Write a one-page memorandum to Stanley explaining the purposes of the four financial statements and how they are linked across time.

## TAKING IT TO THE NET

A1



**BTN 2-5** Access EDGAR online ([www.sec.gov](http://www.sec.gov)) and locate the 2009 year 10-K report of **Amazon.com** (ticker AMZN) filed on January 29, 2010. Review its financial statements reported for years ended 2009, 2008, and 2007 to answer the following questions.

### Required

1. What are the amounts of its net income or net loss reported for each of these three years?
2. Do Amazon's operating activities provide cash or use cash for each of these three years?
3. If Amazon has a 2009 net income of more than \$900 million and 2009 operating cash flows of more than \$3,000 million, how is it possible that its cash balance at December 31, 2009, increases by less than \$700 million relative to its balance at December 31, 2008?

## TEAMWORK IN ACTION

C1 C2 C4 A1

**BTN 2-6** The expanded accounting equation consists of assets, liabilities, common stock, dividends, revenues, and expenses. It can be used to reveal insights into changes in a company's financial position.

### Required

1. Form *learning teams* of six (or more) members. Each team member must select one of the six components and each team must have at least one expert on each component: (a) assets, (b) liabilities, (c) common stock, (d) dividends, (e) revenues, and (f) expenses.
2. Form *expert teams* of individuals who selected the same component in part 1. Expert teams are to draft a report that each expert will present to his or her learning team addressing the following:
  - a. Identify for its component the (i) increase and decrease side of the account and (ii) normal balance side of the account.
  - b. Describe a transaction, with amounts, that increases its component.
  - c. Using the transaction and amounts in (b), verify the equality of the accounting equation and then explain any effects on the income statement and statement of cash flows.
  - d. Describe a transaction, with amounts, that decreases its component.
  - e. Using the transaction and amounts in (d), verify the equality of the accounting equation and then explain any effects on the income statement and statement of cash flows.
3. Each expert should return to his/her learning team. In rotation, each member presents his/her expert team's report to the learning team. Team discussion is encouraged.

## ENTREPRENEURIAL DECISION

A1 A2 P3



**BTN 2-7** Assume Susie Levitt and Katie Shea of **CitySlips** plan on expanding their business to accommodate more product lines. They are considering financing their expansion in one of two ways: (1) contributing more of their own funds to the business or (2) borrowing the funds from a bank.

### Required

Identify at least two issues that Susie and Katie should consider when trying to decide on the method for financing their expansion.



**BTN 2-8** Lisa Langely is a young entrepreneur who operates Langely Music Services, offering singing lessons and instruction on musical instruments. Langely wishes to expand but needs a \$15,000 loan. The bank requests Langely to prepare a balance sheet and key financial ratios. Langely has not kept formal records but is able to provide the following accounts and their amounts as of December 31, 2011.

Cash . . . . .	\$ 1,800	Accounts Receivable . . . .	\$4,800	Prepaid Insurance . . . . .	\$ 750
Prepaid Rent . . . . .	4,700	Store Supplies . . . . .	3,300	Equipment . . . . .	25,000
Accounts Payable . . . . .	1,100	Unearned Lesson Fees . . . .	7,800	Total Equity* . . . . .	31,450
Annual net income . . . . .	20,000				

\* The total equity amount reflects all owner investments, dividends, revenues, and expenses as of December 31, 2011.

### Required

1. Prepare a balance sheet as of December 31, 2011, for Langely Music Services. (Report only the total equity amount on the balance sheet.)
2. Compute Langely's debt ratio and its return on assets (the latter ratio is defined in Chapter 1). Assume average assets equal its ending balance.
3. Do you believe the prospects of a \$15,000 bank loan are good? Why or why not?

**BTN 2-9** Obtain a recent copy of the most prominent newspaper distributed in your area. Research the classified section and prepare a report answering the following questions (attach relevant classified clippings to your report). Alternatively, you may want to search the Web for the required information. One suitable Website is **CareerOneStop** ([www.CareerOneStop.org](http://www.CareerOneStop.org)). For documentation, you should print copies of Websites accessed.

1. Identify the number of listings for accounting positions and the various accounting job titles.
2. Identify the number of listings for other job titles, with examples, that require or prefer accounting knowledge/experience but are not specifically accounting positions.
3. Specify the salary range for the accounting and accounting-related positions if provided.
4. Indicate the job that appeals to you, the reason for its appeal, and its requirements.

**BTN 2-10** **Nokia** ([www.Nokia.com](http://www.Nokia.com)) is a leading global manufacturer of mobile devices and services, and it competes to some extent with both **Research In Motion** and **Apple**. Key financial ratios for the current fiscal year follow.

Key Figure	Nokia	Research In Motion	Apple
Return on assets . . . . .	0.7%	26.8%	19.7%
Debt ratio . . . . .	58.7%	25.5%	33.4%

### Required

1. Which company is most profitable according to its return on assets?
2. Which company is most risky according to the debt ratio?
3. Which company deserves increased investment based on a joint analysis of return on assets and the debt ratio? Explain.

## ENTREPRENEURIAL DECISION

A1 A2 P3  

## HITTING THE ROAD

C1

## GLOBAL DECISION

A2  

**NOKIA**

**RIM**

Apple

## ANSWERS TO MULTIPLE CHOICE QUIZ

1. b; debit Utility Expense for \$700, and credit Cash for \$700.
2. a; debit Cash for \$2,500, and credit Unearned Lawn Service Fees for \$2,500.
3. c; debit Cash for \$250,000, debit Land for \$500,000, and credit Common Stock for \$750,000.
4. d
5. e; Debt ratio =  $\$400,000/\$1,000,000 = \underline{40\%}$