Module 3

Transactions, Adjustments, and Financial Statements

Learning Objectives

LO1 Explain the accounting cycle, and construct the financial statement effects template. (p. 3-3)

LO2 Apply the financial statement effects template to analyze accounting transactions. (p. 3-6)

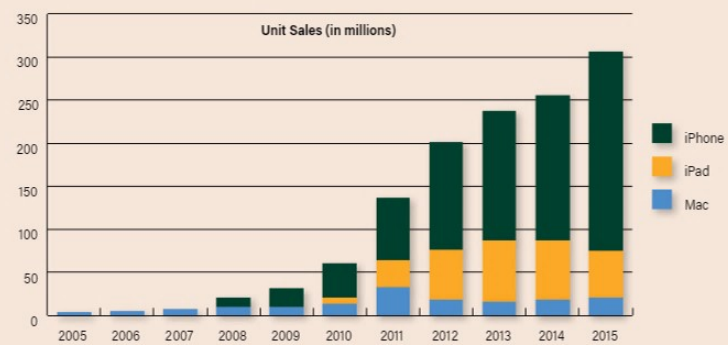
LO3 Prepare and explain accounting adjustments and their financial statement effects. (p. 3-9)

LO4 Construct financial statements from accounting records. (p. 3-13)

LO5 Explain and apply the closing process. (p. 3-16)

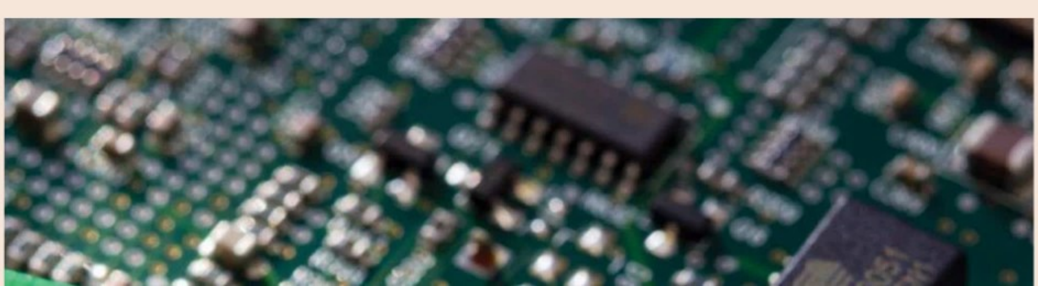
AAPL
Market cap: $639,939 mil
Total assets: $290,479 mil
Revenues: $233,715 mil
Net income: $53,394 mil

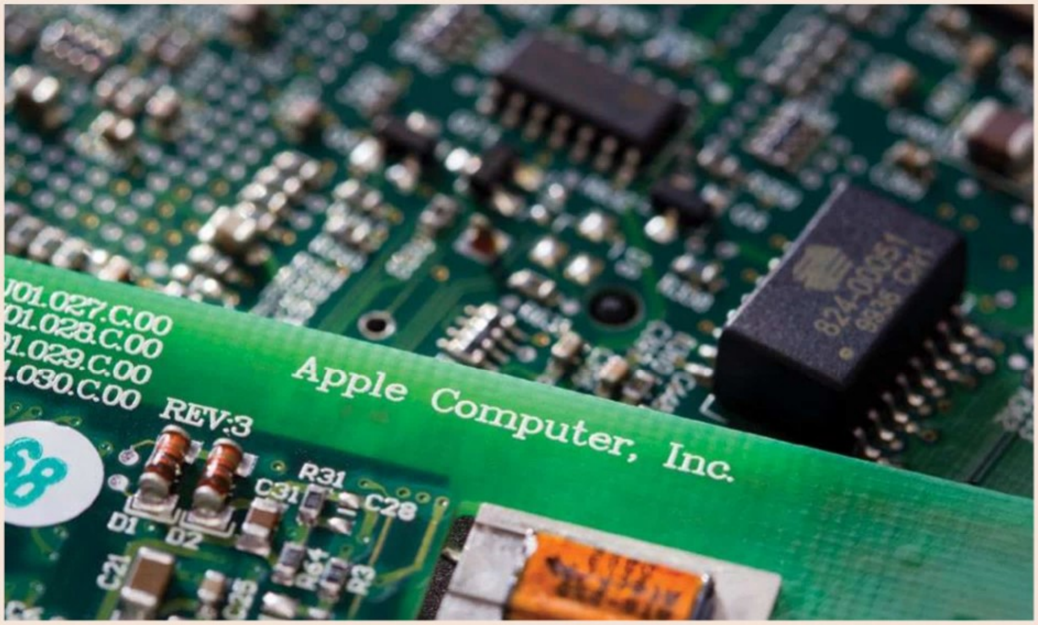
Apple Inc. launched the iPhone ten years ago, which is one of the most important products in its history. As of today, Apple has sold over 800 million iPhones, eight times the number of iPads and Mac products combined, as shown in the following.



To bring each iPhone to market, Apple must purchase component parts, manufacture them, hire sales personnel, pay advertisers, and distribute finished products. Each of these activities involves a transaction that Apple's accounting system must capture and communicate to its stakeholders.

This module explains how the accounting system captures business transactions, creates financial records, and aggregates the individual records to produce financial reports we read and interpret in company 10-Ks. The resulting financial statements tell the story of Apple's business activities. We analyze those financial statements for insights into company operations and future performance. [Source: *Apple*, 2015 10-K.]



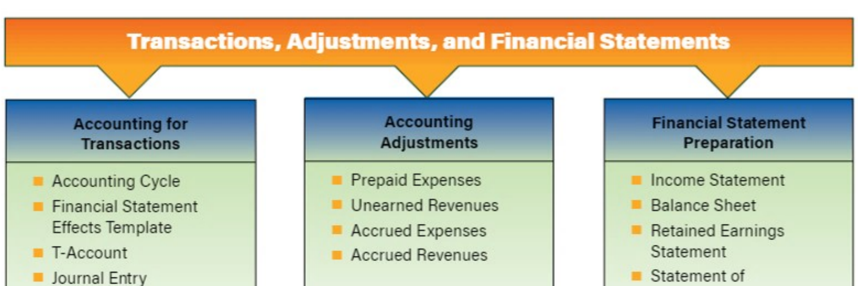


© iStock

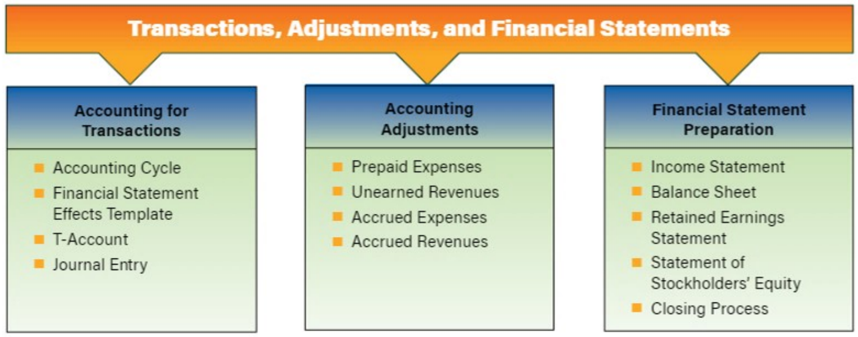
Road Map

LO	Learning Objective | Topics	Page	eLecture	Guided Example	Assignments
3-1	**Explain the accounting cycle, and construct the financial statement effects template.** Accounting Cycle :: Template :: T-Account :: Journal Entry	3-3	e3-1	Review 3-1	1, 2, 3, 4, 7, 8
3-2	**Apply the financial statement effects template to analyze accounting transactions.** Transactions :: Applying the Template :: Applying the T-Account and Journal Entry	3-6	e3-2	Review 3-2	5, 6, 9, 10, 12, 13, 14, 15, 16, 17, 21, 24, 28, 29, 30, 36, 37, 39, 40, 42, 44, 45, 46, 47, 48, 49, 50, 56, 57, 58, 59, 60, 62, 63
3-3	**Prepare and explain accounting adjustments and their financial statement effects.** Prepaid Expenses :: Unearned Revenues :: Accrued Expenses :: Accrued Revenues	3-9	e3-3	Review 3-3	5, 6, 16, 17, 18, 20, 26, 27, 29, 30, 31, 32, 33, 34, 35, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 57, 58, 60, 64, 65, 66
3-4	**Construct financial statements from accounting records.** Income Statement :: Retained Earnings Statement :: Balance Sheet :: Statement of Equity	3-13	e3-4	Review 3-4	11, 18, 19, 22, 26, 27, 41, 43, 55, 56, 58, 59, 60, 64
3-5	**Explain and apply the closing process.** Revenue Accounts :: Expense Accounts :: Dividend Account	3-16	e3-5	Review 3-5	11, 23, 25, 32, 38, 41, 55, 61

Module Organization



Module Organization



eLectures MBC **LO1** Explain the accounting cycle, and construct the financial statement effects template.

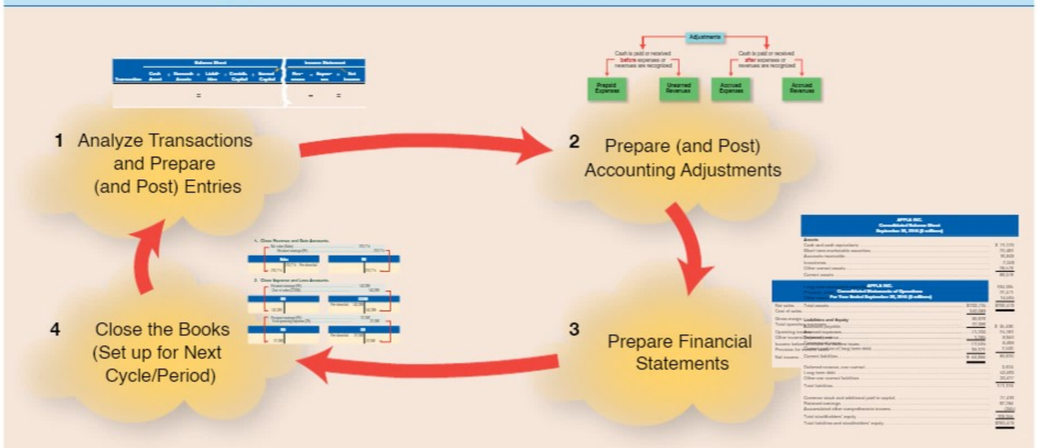
Financial statements report on the financial performance and condition of a business. Those statements are tied to a period or point in time. The period of time is referred to as the accounting cycle, and each cycle consists of four activities.

Four-Step Accounting Cycle

The *accounting cycle* is illustrated in Exhibit 3.1.

- **Step 1** Record transactions in the accounting records. Each transaction is the result of an external or internal transaction or event, such as a sale to a customer or the payment of wages to employees.
- **Step 2** Prepare accounting adjustments, which recognize a number of events that have occurred but that have not yet been recorded. These might include the recognition of wage expense and the related wages payable for those employees who have earned wages but have not yet been paid or of depreciation expense for buildings and equipment.
- **Step 3** Prepare financial statements.
- **Step 4** Close the books in anticipation of the start of a new accounting cycle.

Exhibit 3.1 ■ **Accounting Cycle**



The purpose of this module is to explain the accounting cycle. We use Apple's financials to illustrate the four steps in the accounting cycle. Understanding the financial statement preparation process requires an understanding of the language used to record business transactions in accounting records. The recording

and statement preparation processes are readily understood once we learn that language (of financial statement effects) and its mechanics (entries and posting). Even if we never journalize a transaction or prepare a financial statement, understanding the accounting process aids us in analyzing and interpreting accounting reports. Understanding the accounting language also facilitates our communication with business professionals within a company and with members of the business community outside of a company.

Financial Statement Effects Template

As of its 2015 year-end, Apple reports total assets of $290,479 million, total liabilities of $171,124 and statement preparation processes are readily understood once we learn that language (of financial statement effects) and its mechanics (entries and posting). Even if we never journalize a transaction or prepare a financial statement, understanding the accounting process aids us in analyzing and interpreting accounting reports. Understanding the accounting language also facilitates our communication with business professionals within a company and with members of the business community outside of a company.

Financial Statement Effects Template

As of its 2015 year-end, Apple reports total assets of $290,479 million, total liabilities of $171,124 million, and equity of $119,355 million. The accounting equation for Apple follows ($ millions).

Assets	=	Liabilities	+	Equity
$290,479	=	$171,124	+	$119,355

As financial statement users, we often draw on this relation to assess the effects of transactions and events, different accounting methods, and choices that managers make in preparing financial statements. For example, we are interested in knowing the effects of an asset acquisition or sale on the balance sheet, income statement, and cash flow statement. Or, we might want to understand how the failure to recognize a liability would understate liabilities and overstate profits and equity. A useful tool to perform these sorts of analysis is the following **financial statement effects template**.

	Balance Sheet									Income Statement				
Transaction	Cash Asset	+	Noncash Assets	=	Liabil-ities	+	Contrib. Capital	+	Earned Capital	Rev-enues	–	Expen-ses	=	Net Income
				=							–		=	

Debit.....#
Credit.........#

Acct. Name
#

Acct. Name
#

The template captures the transaction and its effects on the four financial statements: balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. For the balance sheet, we differentiate between cash and noncash assets so as to identify the cash effects of transactions. Likewise, equity is separated into the contributed and earned capital components. Finally, income statement effects are separated into revenues, expenses, and net income (the updating of retained earnings is denoted with an arrow line running from net income to earned capital). This template provides a convenient means to represent relatively complex financial accounting transactions and events in a simple, concise manner for both analysis and interpretation.

In addition to using the template to show the dollar effects of a transaction on the four financial statements, we also include each transaction's *journal entry* and *T-account* representation in the margin. We explain journal entries and T-accounts in the next section; these are part of the bookkeeping aspects of accounting. The margin entries can be ignored without any loss of insight gained from the template.

T-Accounts

The **T-account**, named for its likeness to a "T," is used to reflect increases and decreases to individual accounts. When a transaction occurs, it is recorded (*journalized*); once recorded, the specific accounts affected are updated in the accounting books (*general ledger*) of the company, and the affected accounts are increased or decreased. This process of continuously updating individual account balances is referred to as *posting* transactions to accounts. A T-account provides a simple illustration of the financial effects of each transaction.

Specifically, one side of the T-account is used for increases and the other for decreases. A convenient way to remember which side records increases is to recall the accounting equation: **Assets = Liabilities + Equity**. Assets are on the left side of the equation. So, the left side of an asset T-account records increases in the asset (referred to as the *normal balance* side), and the right side records decreases. Liabilities and equity are on the right side of the accounting equation. So, the right side of a liability and an equity T-account records increases (the *normal balance* side), and the left side records decreases. This relation is represented graphically as follows.

Assets		=	Liabilities		+	Equity	
+ Increases Normal bal.	– Decreases		– Decreases	+ Increases Normal bal.		– Decreases	+ Increases Normal bal.

Journal Entries

Journal entries also capture the effects of transactions. Journal entries reflect increases and decreases to accounts using the language of debits and credits. Debits and credits simply refer to the left or right side of a T-account, respectively.

Assets		=	Liabilities		+	Equity	
+ Increases Normal bal.	− Decreases		− Decreases	+ Increases Normal bal.		− Decreases	+ Increases Normal bal.

Journal Entries

Journal entries also capture the effects of transactions. Journal entries reflect increases and decreases to accounts using the language of debits and credits. Debits and credits simply refer to the left or right side of a T-account, respectively.

Account Title	
Debit (Left side)	Credit (Right side)

The left side of the T-account is the debit side, and the right side is the credit side. This holds for all T-accounts. Thus, to record an increase in an asset, we enter an amount on the left, or debit, side of the T-account—that is, we *debit* the account. Decreases in assets are recorded with an entry on the opposite (credit) side. To record an increase in a liability or equity account, we enter an amount on the right, or credit, side of the T-account—we *credit* the account. Decreases in liability or equity accounts are recorded on the left (debit) side.

In the margin of our financial statement effects template, we show the journal entry first, followed by the related T-accounts. In accounting jargon, this sequence relates to *journalizing* the entry and *posting* it to the affected accounts. The T-accounts represent the financial impact of each transaction on the respective asset, liability, or equity accounts.

Review 3-1 LO1

Guided Examples MBC

The table below shows account names (in alphabetical order) from the balance sheet and income statement for **Apple Inc.**

Required

Indicate the column where each item best fits. The seven columns correspond to the seven account categories in the financial statement effects template.

	Cash Asset	Noncash Asset	Liabilities	Contributed Capital	Earned Capital	Revenues	Expenses
Accounts payable							
Accounts receivable, less allowances							
Accrued expenses							
Acquired intangible assets, net							
Cash and cash equivalents							
Common stock and additional paid-in capital							
Cost of sales							
Current portion of long-term debt							
Deferred revenue							
Deferred tax assets							
Goodwill							
Inventories							
Long-term debt							
Long-term marketable securities							
Net sales							
Other current assets							
Other non-current liabilities							
Property, plant, and equipment, net							

continued

(continued)	Cash Asset	Noncash Asset	Liabilities	Contributed Capital	Earned Capital	Revenues	Expenses
Provision for income taxes							
Research and development							
Retained earnings							
Selling, general, and administrative							

Solution on p. 3-35.

(continued)	Cash Asset	Noncash Asset	Liabilities	Contributed Capital	Earned Capital	Revenues	Expenses
Provision for income taxes	____	____	____	____	____	____	____
Research and development	____	____	____	____	____	____	____
Retained earnings	____	____	____	____	____	____	____
Selling, general, and administrative	____	____	____	____	____	____	____

Solution on p. 3-35.

Accounting Cycle Step 1—Analyze Transactions and Prepare Entries

eLectures MBC **LO2** Apply the financial statement effects template to analyze accounting transactions.

This section uses **Apple Inc.**, to illustrate the accounting for selected business transactions. The assumed time frame is one fiscal year. We will begin with the account balances for Apple at the start of the 2015 fiscal year and illustrate the four steps in the accounting cycle. We construct its 2015 financial statements and close its books.

Apple's Transactions

This section provides a comprehensive two-part illustration using the financial statement effects template with a number of transactions underlying Apple's 2015 financial statements.

- These summary transactions are described in the far left column of Exhibit 3.2, with their financial statement effects shown to the right-hand-side.
- Detailed explanations for each of the 16 fiscal year transactions are provided in Exhibit 3.3.

Applying the Financial Statement Effects Template

To illustrate Step 1 of the accounting cycle, we consider 16 transactions for Apple. Once details of each transaction are known to Apple's accounting department, entries are made in the company's accounting system. For our learning purposes, we use the financial statement effects template to record these transactions. (Adjusting entries in transactions 17 through 20 are described in the next section.)

In the first two rows of Exhibit 3.2, we present each of Apple's balance sheet accounts and related balances as of September 27, 2014. (The end of its 2014 fiscal year is the beginning of its 2015 fiscal year.) We have aggregated some accounts from the Apple balance sheet to keep the size of the financial statement effects template presentable.

Applying the Journal Entry and T-Account

Although we will not repeatedly refer to journal entries and T-accounts, we will describe them for the first transaction in Exhibit 3.2. Specifically, the $4,103 debit equals the $4,103 credit in the journal entry: assets ($4,103 cash) = liabilities ($0) + equity ($4,103 common stock). This balance in transactions is the basis of *double-entry accounting*. For simplicity, we use acronyms (such as CS for common stock) in journal entries and T-accounts. (A listing of accounts and acronyms is located in Appendix B near the end of the book.) The journal entry for this transaction is

	Debit	Credit
Cash	4,103	
CS (common stock)		4,103

Convention dictates that debits are listed first, followed by credits—the latter are indented.[1] The total debit(s) must always equal the total credit(s) for each transaction. The T-account representation for this transaction follows.

[1] There can be more than one debit and one credit for a transaction. To illustrate, assume that Apple raises $300 cash, with $200 from investors and $100 borrowed from a bank. The resulting journal entry is:

	Debit	Credit
Cash	300	
CS (common stock)		200
NP (note payable)		100

Cash		CS	
4,103			4,103

Cash is an asset; thus, a cash increase is recorded on the left or debit side of the T-account. Common stock (CS) is an equity account; thus, a common stock increase is recorded on the right or credit side.

Exhibit 3.2 Financial Statement Effects Template for Apple 2014–2015 ($ millions)

Cash	
4,103	

CS	
	4,103

Cash is an asset; thus, a cash increase is recorded on the left or debit side of the T-account. Common stock (CS) is an equity account; thus, a common stock increase is recorded on the right or credit side.

Exhibit 3.2 Financial Statement Effects Template for Apple 2014–2015 ($ millions)

	Balance Sheet					Income Statement		
Transaction	Cash Asset	+ Noncash Assets	= Liabilities	+ Contrib. Capital	+ Earned Capital*	Revenues	− Expenses	= Net Income
September 27, 2014	13,844	217,995	120,292	23,313	88,234			
Step 1—Analyze Transactions, and Prepare Entries								
1. Issue common stock for $4,103 cash	4,103			4,103 Common stock				
2. Purchase $140,327 of inventory on credit		140,327 Inventory	140,327 Accounts payable					
3. Sell inventory costing $140,089 for $225,224 on credit		(140,089) Inventory 225,224 Accounts receivable			85,135	225,224 Sales	140,089 Cost of sales	85,135
4. Receive $225,835 cash on accounts receivable	225,835	(225,835) Accounts receivable						
5. Pay $135,033 cash toward accounts payable	(135,033)		(135,033) Accounts payable					
6. Pay $4,411 cash for operating expenses and taxes	(4,411)				(4,411)		4,411 Operating expenses	(4,411)
7. Pay $11,247 cash for plant assets (PPE)	(11,247)	11,247 PPE						
8. Pay $43,151 cash for short-term and long-term marketable securities	(43,151)	43,151 Marketable securities						
9. Issue short-term debt for $2,191 cash	2,191		2,191 Short-term debt					
10. Issue long-term debt for $26,976 cash	26,976		26,976 Long-term debt					
11. Pay $514 cash in interest expense	(514)				(514)		514 Interest expense	(514)
12. Pay $11,627 cash dividends to stockholders	(11,627)				(11,627)			
13. Receive $9,533 cash from customers for products and services to be delivered later	9,533		9,533 Unearned revenue					
14. Receive $1,799 cash in dividends and interest on marketable securities	1,799				1,799		(1,799) Other non-operating income	1,799
15. Pay $19,121 cash for income taxes	(19,121)				(19,121)		19,121 Income taxes	(19,121)
16. Misc. transactions	(38,057)	8,596	8,601		(38,062)			
Step 2—Prepare Accounting Adjustments								
17. Accrue expenses of $6,728			6,728 Accrued expenses		(6,728)		6,728 Operating expenses	(6,728)
18. Record depreciation expense of $9,400		(9,400) PPE			(9,400)		9,400 Depreciation expense	(9,400)
19. Record amortization expense of $1,857		(1,857) Other assets			(1,857)		1,857 Amortization expense	(1,857)
20. Apple earns previously deferred revenue of $8,491			(8,491) Unearned revenue		8,491	8,491 Sales		8,491
September 26, 2015	21,120	269,359	171,124	27,416	91,939	233,715	180,321	53,394

* Earned capital includes retained earnings and other equity accounts.

Exhibit 3.3 Details of Transactions for Apple 2014–2015 ($ millions)

Transaction	Description
1. Issue common stock for $4,103 million cash	Cash, common stock, and additional paid-in capital all increase by the proceeds from issuance. (Apple combines common stock and additional paid-in capital on its balance sheet.) The sale of stock is not revenue. It is a financing transaction between the company and its owners (stockholders). Neither the sale or repurchase of stock, nor the payment of dividends to shareholders, affects revenue or expense. Transactions with stockholders never affect net income.
2. Purchase $140,327 million of inventories on account	Inventories are often purchased on account, meaning that suppliers give the company a period of time in which to pay for the purchase. Inventory increases by the purchase price. Because the company has not yet paid for the purchase

Exhibit 3.3 ■ **Details of Transactions for Apple 2014–2015 ($ millions)**

Transaction	Description
1. Issue common stock for $4,103 million cash	Cash, common stock, and additional paid-in capital all increase by the proceeds from issuance. (Apple combines common stock and additional paid-in capital on its balance sheet.) The sale of stock is not revenue. It is a financing transaction between the company and its owners (stockholders). Neither the sale or repurchase of stock, nor the payment of dividends to shareholders, affects revenue or expense. Transactions with stockholders never affect net income.
2. Purchase $140,327 million of inventories on account	Inventories are often purchased on account, meaning that suppliers give the company a period of time in which to pay for the purchase. Inventory increases by the purchase price. Because the company has not yet paid for the purchase, accounts payable (a liability) also increases by the purchase price. Note that inventories are not recorded at their expected retail selling price.
3. Sell inventories that cost $140,089 million for $225,224 million on credit	The sale of inventory has two distinct parts: a) **Recognize revenue.** Revenue (net sales) can be recognized because ownership of inventory has transferred to the customer. Because the customer has not yet paid for the inventory, the amount owed to Apple is reported as an account receivable. In order to recognize revenue, Apple has to have performed its part of the sales contract (given possession of the inventory to the customer). The receipt of cash is not required to recognize revenue; an agreement to pay later is sufficient. b) **Record expense.** The cost of inventory is recognized as an expense at the time of sale. An asset remains on the balance sheet until it is used, at which time its cost is transferred to the income statement as an expense. Because Apple has now sold (used) the inventory, its cost is moved from the inventory account on the balance sheet to the income statement as an expense called cost of goods sold.
4. Receive $225,835 million cash on accounts receivable	Cash increases when customers settle their accounts and the accounts receivable balance decreases. Collection of a receivable is not revenue. Instead, revenue is recognized when earned, as in transaction 3.
5. Pay $135,033 million cash toward accounts payable	Cash and accounts payable both decrease by the amount paid to suppliers to settle the account. Note that payment of a payable is not an expense. The expense was recognized when it was incurred, as in transaction 3.
6. Pay $4,411 million cash for operating expenses.	Operating expenses are costs incurred to earn revenue and do business. An example is salaries expense. Cash decreases when employees are paid and salaries expense is recorded in the income statement.
7. Pay $11,247 million cash for property, plant, and equipment (PPE).	Cash decreases and PPE assets increase for the purchase price. The purchase of PPE is not an expense. PPE is reported as an asset on the balance sheet because it creates future (longer-term) economic value. Over time, as PPE is used, its cost is transferred to the income statement as an expense called depreciation expense.
8. Pay $9,248 million and $33,903 million cash to purchase short-term and long-term marketable securities, respectively.	Apple invests its excess cash in marketable securities. This means cash decreases, and marketable securities accounts increase. The company plans to hold some of the investments for a year or less (short-term) and some for longer (long-term), depending on anticipated future cash needs. In the interim, the investments allow the company to earn interest, dividends, and any appreciation in value.
9. Issue commercial paper for $2,191 million cash.	Apple issues commercial paper, a common type of short-term debt. Cash increases by the proceeds of the issuance, and we record an increase in short-term debt on the balance sheet.
10. Issue long-term debt for $26,976 million cash.	Cash increases by the amount of the proceeds, and a long-term liability is recognized for the amount owed. It is classified as long-term because it will not be repaid during the current year. In the year that it matures, the balance to be repaid is moved to the current liability section of the balance sheet as an account called current maturities of long-term debt. As with the sale of stock, neither borrowing of money, nor its repayment, is recognized as revenue or expense. Only the payment of interest on the debt is an expense.
11. Pay $514 million in cash interest expense.	Apple pays interest on its short-term and long-term debts. Cash decreases, and expenses increase by the amount paid. Interest expense is a nonoperating expense—it is not incurred in ordinary operating activities but for financing activities.
12. Pay $11,627 million cash dividends to stockholders.	Cash and retained earnings both decrease from the dividend. The payment of dividends is not an expense. It is a transaction with the company's owners (the stockholders), not with its customers, and no expense is recognized in the income statement. Dividends are paid out of the retained profits of the company, which reduces retained earnings.
13. Receive $9,533 million cash from customers for products and services that are delivered later: $8,940 million within a year and $593 million after a year.	This does not represent revenue because Apple will not deliver the goods and services until later. Apple has not earned the revenue and cannot record the amount on the income statement. Instead, Apple records the amount as a liability, deferred revenue, to reflect the fact that Apple has an obligation to deliver the goods and perform the services. The amount that will be delivered within a year is classified as current liability and the remainder as a long-term liability.
14. Receive $1,799 million cash in dividends and interest on marketable securities.	Cash increases, as does other nonoperating income on the income statement. This nonoperating income includes dividends, interest, and capital gains Apple earns on its short-term and long-term marketable securities. This is not classified as revenue because it is not earned from customers. The financial statement effects template shows the opposite sign of interest expense from transaction 11. We recorded other nonoperating income as a negative expense, which lets us know it is an income item and not an expense.
15. Pay $19,121 million cash for income taxes.	Cash decreases, and tax expense is recognized in the income statement.
16. Record various other transactions.	We aggregate the remaining transactions to Apple's financial statements in this row. These entries affect various balance sheet accounts and transactions we discuss later in the book. None of these transactions affects the income statement.

Review 3-2 LO2

Guided Example MBC

Prestige Inc. experienced the following 12 transactions during the month of January 2017.

1. Issue common stock for $3,000 cash.
2. Purchase inventory for $8,000 on credit.
3. Sell inventory costing $8,000 for $15,000 on credit.
4. Issue long-term debt for $10,000 cash.
5. Pay $15,000 cash for property, plant, and equipment (PPE).
6. Pay $500 cash for salaries.
7. Receive $300 cash in advance from client for future consulting services.

Review 3-2 LO2

Prestige Inc. experienced the following 12 transactions during the month of January 2017.

1. Issue common stock for $3,000 cash.
2. Purchase inventory for $8,000 on credit.
3. Sell inventory costing $8,000 for $15,000 on credit.
4. Issue long-term debt for $10,000 cash.
5. Pay $15,000 cash for property, plant, and equipment (PPE).
6. Pay $500 cash for salaries.
7. Receive $300 cash in advance from client for future consulting services.
8. Pay $50 cash for interest on long-term debt.
9. Receive $3,000 cash from accounts receivable.
10. Pay $2,500 cash toward accounts payable.
11. Perform consulting services for client who previously paid in transaction 7.
12. Pay $100 cash for dividends.

Required

Record each transaction in the financial statement effects template. The beginning balances for each account are entered into the template. *Note:* The template includes rows for transactions 13 through 16, which are covered in later Reviews in the module.

	Balance Sheet					Income Statement		
	Cash Assets +	Noncash Assets =	Liabilities +	Contrib. Capital +	Earned Capital	Revenues −	Expenses =	Net Income
Balance January 1, 2017	10,000	41,000	26,000	10,000	15,000	0	0	0
Transactions								
1. Issue common stock for $3,000 cash								
2. Purchase inventory for $8,000 on credit								
3. Sell inventory costing $8,000 for $15,000 on credit								
4. Issue long-term debt for $10,000 cash								
5. Pay $15,000 cash for PPE								
6. Pay $500 cash for salaries								
7. Receive $300 cash in advance for future consulting services								
8. Pay $50 cash for interest on long-term debt								
9. Receive $3,000 cash from accounts receivable								
10. Pay $2,500 cash toward accounts payable								
11. Perform consulting services for client who previously paid in 7								
12. Pay $100 cash for dividends								
Accounting Adjustments								
13. Record depreciation of $600								
14. Accrue salaries of $1,000								
15. Advertising costing $1,300 is aired								
16. Accrue income taxes of $1,200								
Balance January 31, 2017								

Solution on p. 3-36.

Accounting Cycle Step 2—Prepare Accounting Adjustments

LO3 Prepare and explain accounting adjustments and their financial statement effects.

Recognizing revenue when products and services are delivered at an amount expected to be received (even if not received in cash) *and* recording expenses when incurred (even if not paid in cash) are cornerstones of **accrual accounting**, which is required under GAAP. In addition, understanding accounting adjustments, commonly called *accruals*, is crucial to effectively analyzing and interpreting financial statements.

In this module's Apple illustration, we recorded inventory as a purchase even though no cash was paid, and we recognized the sale as revenue even though no cash was received. Both of these transactions reflect accrual accounting. Some accounting adjustments affect the balance sheet alone (as with purchasing inventory on account in Exhibit 3.2, transaction 2). Other adjustments affect the balance sheet *and* the income statement (as with selling inventory on account in Exhibit 3.2, transaction 3). Accounting adjustments can affect asset, liability, or equity accounts and can either increase or decrease net income.

Companies make adjustments to more accurately report their financial performance and condition. For example, employees might not have been paid for wages earned at the end of an accounting period. Failure to recognize this labor cost would understate the company's total liabilities (because wages payable would be too low) and would overstate net income for the period (because wages expense would be

too low). Thus, neither the balance sheet nor the income statement would be accurate without accounting adjustments.

Four Types of Accounting Adjustments Exhibit 3.4 identifies four general types of accounting adjustments, which are briefly described here.

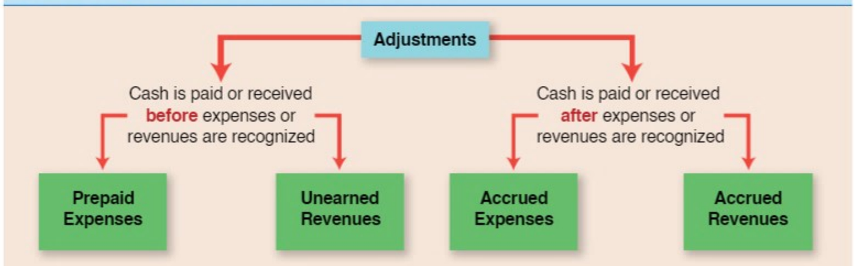
- **Prepaid expenses** Prepaid expenses reflect advance cash payments that will ultimately become expenses. An example is the payment for radio advertising that will not be aired until sometime in the future.

too low). Thus, neither the balance sheet nor the income statement would be accurate without accounting adjustments.

Four Types of Accounting Adjustments Exhibit 3.4 identifies four general types of accounting adjustments, which are briefly described here.

- **Prepaid expenses** Prepaid expenses reflect advance cash payments that will ultimately become expenses. An example is the payment for radio advertising that will not be aired until sometime in the future.
- **Unearned revenues** Unearned revenues reflect cash received from customers before any services or goods are provided. An example is cash received from patrons for tickets to an upcoming concert.
- **Accrued expenses** Accrued expenses are expenses incurred and recognized on the income statement even though they are not yet paid in cash. An example is wages owed to employees who performed work but who have not yet been paid.
- **Accrued revenues** Accrued revenues are revenues earned and recognized on the income statement even though cash is not yet received. Examples include sales on credit and revenue earned under a long-term contract.

Exhibit 3.4 ■ **Four Types of Accounting Adjustments**



The remainder of this section illustrates how **Apple**'s financial statements would reflect each of these four types of adjustments.

Prepaid Expenses

Assume Apple pays $200 to purchase time on **MTV** for iPod ads. Apple's cash account decreases by $200. Should the $200 advertising cost be recorded as an expense when Apple pays MTV, when MTV airs the ads, or at some other point? Under accrual accounting, Apple must record an expense when it is incurred. That means Apple should expense the cost of the ads when MTV airs them. When Apple pays for the advertisement, it records an asset; Apple "owns" air time that will presumably provide future benefits when the ads air. In the interim, the cost of the ads is an asset on the balance sheet. Apple's financial statement effects template follows for this transaction. There is a decrease in cash and an increase in the advertising asset, called prepaid advertising, when the ad time is paid for. At period-end, $50 of advertisements had aired. At that point, Apple must record an accounting adjustment to reduce the prepaid advertising account by $50 and transfer the cost to the income statement as advertising expense.

	Balance Sheet									Income Statement				
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	−	Expenses	=	Net Income
Pay $200 cash in advance for ad time	−200 Cash		+200 Prepaid Advertising	=							−		=	
Record $50 cost of ad air time			−50 Prepaid Advertising	=					−50 Retained Earnings		−	+50 Advertising Expense	=	−50

PPDA . 200
Cash 200

PPDA
200 |

Cash
| 200

AE 50
PPDA 50

AE
50 |

PPDA
| 50

Unearned Revenues

Assume Apple receives $400 cash from a customer as advance payment on a multi-unit iPod sale to be delivered next month. Apple must record cash received on its balance sheet but cannot recognize revenue from the order until earned, which is generally when iPods are delivered to the customer. Until then, Apple must recognize a liability called unearned, or deferred, revenue that represents Apple's obligation to fulfill the order at some future point. The financial statement effects template for this transaction follows.

Balance Sheet	Income Statement

Unearned Revenues

Assume Apple receives $400 cash from a customer as advance payment on a multi-unit iPod sale to be delivered next month. Apple must record cash received on its balance sheet but cannot recognize revenue from the order until earned, which is generally when iPods are delivered to the customer. Until then, Apple must recognize a liability called unearned, or deferred, revenue that represents Apple's obligation to fulfill the order at some future point. The financial statement effects template for this transaction follows.

Cash . . 400
UR. 400

Cash: 400 |
UR: | 400

	Balance Sheet							Income Statement				
Transaction	**Cash Asset**	+ **Noncash Assets**	=	**Liabilities**	+ **Contrib. Capital**	+ **Earned Capital**	**Revenues**	−	**Expenses**	=	**Net Income**
Receive $400 cash in advance for iPod sale	+400 Cash		=	+400 Unearned Revenue				−		=	

Assume Apple delivers the iPods a month later (but still within the fiscal quarter). Apple must recognize the $400 as revenue at delivery because it is now earned. Thus, net income increases by $400. The second part of this transaction is to record the cost of the iPods sold. Assuming the cost is $150, Apple reduces iPod inventory by $150 and records cost of goods sold by the same amount. These effects are reflected in the following template.

UR 400
Sales. 400

UR: 400 |
Sales: | 400

COGS . . 150
INV 150

COGS: 150 |
INV: | 150

	Balance Sheet							Income Statement				
Transaction	**Cash Asset**	+ **Noncash Assets**	=	**Liabilities**	+ **Contrib. Capital**	+ **Earned Capital**	**Revenues**	−	**Expenses**	=	**Net Income**
Deliver $400 of iPods paid in advance			=	−400 Unearned Revenues		+400 Retained Earnings	+400 Sales	−		=	+400
Record $150 cost of $400 iPod sale		−150 Inventory	=			−150 Retained Earnings		−	+150 Cost of Goods Sold	=	−150

Accrued Expenses

Assume Apple's sales staff earns $100 of sales commissions this period that will not be paid until next period. The sales staff earned the wages as they made the sales. However, because Apple pays its employees twice a month, the related cash payment will not occur until the next pay period. Should Apple record the wages earned by its employees as an expense even though payment has not yet been made? The answer is yes. The expense recognition principle requires Apple to recognize wages expense when it is *incurred*, even if not paid in cash. It must record wages expense incurred as a liability (wages payable). In the next period, when Apple pays the wages, it reduces both cash and wages payable. Net income is not affected by the cash payment; instead, net income decreased in the previous period when Apple accrued the wage expense.

WE. . . . 100
WP 100

WE: 100 |
WP: | 100

WP. . . . 100
Cash. 100

WP: 100 |
Cash: | 100

	Balance Sheet							Income Statement				
Transaction	**Cash Asset**	+ **Noncash Assets**	=	**Liabilities**	+ **Contrib. Capital**	+ **Earned Capital**	**Revenues**	−	**Expenses**	=	**Net Income**
Current period: Incur $100 of wages not yet paid			=	+100 Wages Payable		−100 Retained Earnings		−	+100 Wages Expense	=	−100
Next period: Pay $100 cash for accrued wages	−100 Cash		=	−100 Wages Payable				−		=	

As another example of accrued expenses, assume Apple rents office space and that it owes $25 in rent at period-end. Apple has incurred rent expense in the current period, and that expense must be recorded this period. Failing to make this adjustment would mean Apple's liabilities (rent payable) would be understated and its income would be overstated. The entry to record the accrual of rent expense for office space follows.

Balance Sheet					Income Statement		
Cash	+ Noncash	= Liabil-	+ Contrib.	+ Earned	Rev-	− Expen-	= Net

As another example of accrued expenses, assume Apple rents office space and that it owes $25 in rent at period-end. Apple has incurred rent expense in the current period, and that expense must be recorded this period. Failing to make this adjustment would mean Apple's liabilities (rent payable) would be understated and its income would be overstated. The entry to record the accrual of rent expense for office space follows.

	Balance Sheet									Income Statement				
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	−	Expenses	=	Net Income
Incur $25 of rent not yet paid				=	+25 Rent Payable				−25 Retained Earnings		−	+25 Rent Expense	=	−25

RNTE . . 25
RNTP 25

RNTE	
25	

RNTP	
	25

Accrued Revenues

Assume Apple delivers iPods to a customer in Boston, Massachusetts, who will pay next quarter. The sales price for those units is $500, and the cost is $400. Apple has completed its revenue earning process with this sale and must accrue revenue from the Boston customer even though Apple received no cash. Like all sales transactions, Apple must record two parts, the sales revenue and the cost of sales. The financial effects template for this two-part transaction follows.

	Balance Sheet									Income Statement				
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	−	Expenses	=	Net Income
Sell $500 of iPods on credit			+500 Accounts Receivable	=					+500 Retained Earnings	+500 Sales	−		=	+500
Record $400 cost of $500 iPod sale			−400 Inventory	=					−400 Retained Earnings		−	+400 Cost of Goods Sold	=	−400

AR 500
Sales. 500

AR	
500	

Sales	
	500

COGS . 400
INV 400

COGS	
400	

INV	
	400

Accounting Adjustments for Apple

Entries 17 through 20 in Exhibit 3.2, which are explained in Exhibit 3.5, reflect the accounting adjustments Apple makes during its fiscal year. These accounting adjustments occur at the end of the accounting period, prior to the preparation of the financial statements. The purpose of accounting adjustments is to adjust balance sheet assets and liabilities so that the financial statements fairly present the company's financial performance and position.

Exhibit 3.5 ■ Details of Accounting Adjustments for Apple 2014–2015 ($ millions)

Adjustment	Description
17. Accrue expenses of $6,728 million	Accrued expenses represent liabilities that have been incurred before the end of the accounting period but have not been recorded. The accrual simultaneously increases liabilities on the balance sheet and expenses in the income statement. Failure to properly accrue expenses would understate liabilities and overstate profit (and retained earnings).
18. Record depreciation expense of $9,400 million	Each period that PPE is used, a portion of the cost of the PPE is transferred to the income statement as *depreciation expense* to reflect the fact that the PPE assets have been used during the period. Failure to record depreciation expense would overstate assets and net income (and retained earnings) for the period.
19. Record amortization expense of $1,857 million	Similar to PPE, certain intangible assets (those that have a limited useful life) are used up over time and amortized. This concept is the same as depreciation, but the word *amortization* is used instead. The accounting adjustment to amortize the intangible assets reduces the balance sheet value of the intangible assets and records an expense. Note that goodwill is not amortized because we assume it has an unlimited useful life. (We discuss intangible assets, including the goodwill asset, in Module 9).
20. Apple earns previously deferred revenue of $8,491 million	When customers pay in advance, Apple records the cash pre-payment as a liability. Once Apple transfers the products or delivers the services to its customers, it can recognize revenue from the sale, typically with an accounting adjustment. The adjustment reduces the unearned revenue liability on the balance sheet and increases revenue in the income statement.

Research Insight ■ Accruals: Good or Bad?

Researchers examine accounting accruals to study the effects of earnings management on financial accounting. Earnings management is broadly defined as the use of accounting discretion to distort reported earnings. Managers have incentives to manage earnings in many situations. For example, managers have tendencies to accelerate revenue recognition to increase stock prices prior to equity offerings. In contrast, other research shows that managers decelerate revenue recognition to depress stock prices prior to a management buyout (where management repurchases common stock and takes the company "private"). Research also shows that managers use discretion when reporting special items to either meet or beat analysts' forecasts of earnings and/or to avoid

Research Insight ■ Accruals: Good or Bad?

Researchers examine accounting accruals to study the effects of earnings management on financial accounting. Earnings management is broadly defined as the use of accounting discretion to distort reported earnings. Managers have incentives to manage earnings in many situations. For example, managers have tendencies to accelerate revenue recognition to increase stock prices prior to equity offerings. In contrast, other research shows that managers decelerate revenue recognition to depress stock prices prior to a management buyout (where management repurchases common stock and takes the company "private"). Research also shows that managers use discretion when reporting special items to either meet or beat analysts' forecasts of earnings and/or to avoid reporting a loss. Not all earnings management occurs for opportunistic reasons. Research shows managers use accruals to communicate private information to outsiders about future profitability. For example, management might signal future profitability through use of income-decreasing accruals to show investors the company can afford to apply conservative accounting. This "signaling" through accruals is found to precede stock splits and dividend increases. In sum, we must look at reported earnings in conjunction with other earnings' quality signals (such as levels of disclosure, degree of corporate governance, and industry performance) to interpret information in accruals.

Review 3-3 LO3

Refer to the information in Review 3-2 for Prestige Inc., which is preparing to record its accounting adjustments for month-end January 2017.

Required

Enter the following accounting adjustments in the financial statement effects template, included in Review 3-2.

13. Record depreciation expense of $600.
14. Accrue salaries of $1,000.
15. Advertising costing $1,300 is aired. Prestige had previously paid cash for the advertising and recorded an asset labeled "Prepaid expense."
16. Accrue income taxes of $1,200.

Solution on p. 3-36.

Accounting Cycle Step 3—Prepare Financial Statements

LO4 Construct financial statements from the accounting records.

Once we enter all of the transactions and adjustments into the financial statement effects template, we sum each column to obtain ending balances for the accounts. This is shown on the bottom row of Exhibit 3.2, and reflects ending balances of accounts after all of the transactions have been recorded during the accounting period in Step 1 and all of the period-end adjustments have been entered into the accounting records in Step 2. With the accounts totaled, we can prepare the financial statements (Step 3).

There is an order to financial statement preparation.

- First, a company prepares its income statement using the income statement accounts. It then uses the net income number and dividend information to update the retained earnings account.
- Second, it prepares the balance sheet using the updated retained earnings account along with the remaining balance sheet accounts.
- Third, it prepares the statement of stockholders' equity.
- Fourth, it prepares the statement of cash flows using information from the cash account (and other sources).

Income Statement

Our financial statement effects spreadsheet in Exhibit 3.2 summarizes Apple's income statement accounts in the last three columns. We use the data from those columns to prepare the income statement

in proper form. Apple aggregates its many operating expenses on a line labeled "Total operating expenses." Apple also combines interest expense with other nonoperating income and reports a line labeled "Other income/(expense), net." Apple's income statement for 2015 follows.

APPLE INC.
Consolidated Statements of Operations
For Year Ended September 26, 2015 ($ millions)

Net sales	$233,715

in proper form. Apple aggregates its many operating expenses on a line labeled "Total operating expenses." Apple also combines interest expense with other nonoperating income and reports a line labeled "Other income/(expense), net." Apple's income statement for 2015 follows.

APPLE INC. **Consolidated Statements of Operations** **For Year Ended September 26, 2015 ($ millions)**	
Net sales	$233,715
Cost of sales	140,089
Gross margin	93,626
Total operating expenses	22,396
Operating income	71,230
Other income/(expense), net	1,285
Income before provision for income taxes	72,515
Provision for income taxes	19,121
Net income	$ 53,394

Apple's income statement includes a subtotal for gross margin, which is a common reporting practice that helps us evaluate company performance and profitability. Apple also reports a subtotal for operating profit. As we will discuss in Module 4, operating profit isolates those activities that create shareholder value and, for that reason, companies frequently report a subtotal for operating profit.

Retained Earnings Statement

Once the income statement is prepared, companies update the retained earnings balance by adding net income and subtracting dividends. We can do likewise using the net income and dividend information from the financial statement effects spreadsheet in Exhibit 3.2. Apple's retained earnings statement for 2015 follows.

APPLE INC. **Retained Earnings Statement** **For Year Ended September 26, 2015 ($ millions)**	
Retained earnings, September 27, 2014	$87,152
Add: Net income	53,394
Deduct: Dividends	(11,627)
Miscellaneous adjustments[1]	(36,635)
Retained earnings, September 26, 2015	$92,284

[1] Miscellaneous adjustments include many items explained in later modules. These include the revaluation of financial derivative instruments and the repurchase and retirement of common stock.

Balance Sheet

Once Apple computes the ending balance in retained earnings, it can prepare its balance sheet. Balance sheet accounts are called **permanent accounts** because their respective balances carry over from one period to the next. For example, the cash balance at the end of the current accounting period (ended September 26, 2015) is $21,120 million, which will be the balance at the beginning of the next accounting period (beginning September 27, 2015).

To prepare the balance sheet, we use the ending balances from the last row in the financial statement effects spreadsheet in Exhibit 3.2, along with specific details for accounts within several of the columns. We then apply proper balance sheet format that has subtotals for current assets, current liabilities, total liabilities, and equity to produce Apple's consolidated balance sheet for 2015 as follows.

APPLE INC. **Consolidated Balance Sheet** **September 26, 2015 ($ millions)**	
Assets	
Cash and cash equivalents	$ 21,120
Short-term marketable securities	20,481
Accounts receivable	16,849
Inventories	2,349
Other current assets	28,579

APPLE INC. **Consolidated Balance Sheet** **September 26, 2015 ($ millions)**	
Assets	
Cash and cash equivalents	$ 21,120
Short-term marketable securities	20,481
Accounts receivable	16,849
Inventories	2,349
Other current assets	28,579
Current assets	89,378
Long-term marketable securities	164,065
Property, plant, and equipment, net	22,471
Other assets	14,565
Total assets	$290,479
Liabilities and equity	
Accounts payable	$ 35,490
Accrued expenses	25,181
Deferred revenue	8,940
Commercial paper	8,499
Current portion of long-term debt	2,500
Current liabilities	80,610
Deferred revenue, non-current	3,624
Long-term debt	53,463
Other non-current liabilities	33,427
Total liabilities	171,124
Common stock and additional paid-in capital,	27,416
Retained earnings	92,284
Accumulated other comprehensive income	(345)
Total shareholders' equity	119,355
Total liabilities and shareholders' equity	$290,479

Statement of Stockholders' Equity

We use the information from the financial statement effects template pertaining to contributed capital and earned capital to prepare the statement of stockholders' equity, as follows. (The final financial statement is the statement of cash flows, which we cover in detail in a later module.)

APPLE INC.
Statement of Shareholders' Equity
For Year Ended September 26, 2015

$ millions	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, September 27, 2014	$23,313	$87,152	$1,082	$111,547
Stock issuance	4,103			4,103
Net income		53,394		53,394
Dividends		(11,627)		(11,627)
Other		(36,635)	(1,427)	(38,062)
Balance, September 26, 2015	$27,416	$92,284	$ (345)	$119,355

LO4 **Review 3-4**

GuidedExamples MBC

Refer to the information in Reviews 3-2 and 3-3 for Prestige Inc., which is preparing its financial statements for month-end January 2017. In addition, the financial statement effects template included the following (beginning) account balances at January 1, 2017.

Accounts receivable	$12,000	Accounts payable	$ 3,800
Inventory	7,200	Unearned revenue	200
Prepaid advertising	1,800	Long-term debt	22,000
PPE	20,000	Salaries payable	0
		Taxes payable	0

LO4 **Review 3-4**

Refer to the information in Reviews 3-2 and 3-3 for Prestige Inc., which is preparing its financial statements for month-end January 2017. In addition, the financial statement effects template included the following (beginning) account balances at January 1, 2017.

GuidedExamples MBC

Accounts receivable	$12,000	Accounts payable	$ 3,800
Inventory	7,200	Unearned revenue	200
Prepaid advertising	1,800	Long-term debt	22,000
PPE	20,000	Salaries payable	0
		Taxes payable	0

Required

1. List the 14 accounts, and determine the ending balance for each.
2. Prepare the income statement, statement of retained earnings, and balance sheet at the end of the period. **Solution on p. 3-37.**

Accounting Cycle Step 4—Close the Books

eLectures MBC **LO5** Explain and apply the closing process.

The **closing process** (or *closing the books*) refers to "zeroing out" the temporary accounts by transferring their ending balances to retained earnings. Income statement accounts—revenues and expenses—and the dividend account are **temporary accounts** because their balances are zero at the start of each accounting period so that only the current period's activities are included. Balance sheet accounts carry over from period to period and are called permanent accounts. The closing process is typically carried out via a series of journal entries that successively zero out each revenue and expense account and the dividend account, transferring those balances to retained earnings. The result is that all income statement accounts and the dividend account begin the next period with zero balances. The balance sheet accounts do not need to be similarly adjusted because their balances carry over from period to period.

Closing with the Template It is important to distinguish our financial statement effects template from companies' accounting systems. The financial statement effects template and T-accounts are pedagogical tools that represent transactions' effects on financial statements. The template is highly stylized, but its simplicity is instructive.

Closing with Journal Entries In practice, managers use journal entries to record transactions and adjustments. The template captures these in summarized fashion. However, in practice, income statement transactions are not automatically transferred to retained earnings, and retained earnings is not continuously updated. Instead, companies have a formal "closing process" at the end of each reporting period—someone or some program must transfer the temporary account balances to retained earnings. Thus, it is important to understand the closing process and why companies "close" the books each period. We describe the mechanical details of the closing process.

Following are the journal entries, along with the T-account entries, **Apple** would make to close out its income statement accounts and dividend account to retained earnings (in millions).

1. Close Revenue and Gain Accounts.

Net sales (Sales)	233,715	
Retained earnings (RE)		233,715

Sales		
	233,715	Pre-close bal.
233,715		

RE	
	233,715

2. Close Expense and Loss Accounts.

Retained earnings (RE)	140,089	
Cost of sales (COGS)		140,089

RE	
140,089	

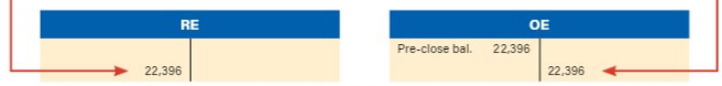
COGS		
Pre-close bal.	140,089	
		140,089

Retained earnings (RE)	22,396	
Total operating expense (OE)		22,396

2. Close Expense and Loss Accounts.

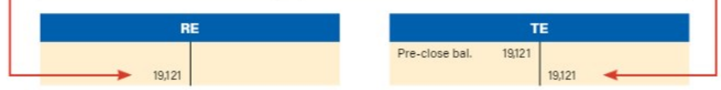
Retained earnings (RE)	140,089	
Cost of sales (COGS)		140,089

Retained earnings (RE)	22,396	
Total operating expense (OE)		22,396



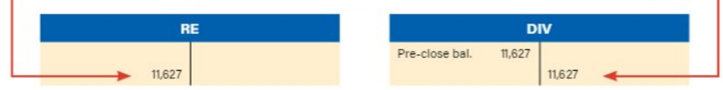
Other income/expense (ONI)	1,285	
Retained earnings (RE)		1,285

Retained earnings (RE)	19,121	
Provision for income taxes (TE)		19,121



3. Close Dividend Account.

Retained earnings (RE)	11,627	
Dividends (DIV)		11,627



The closing process reduces all of the income statement accounts and the dividend account to zero to begin the next accounting period with a zero balance. This means revenues, expenses, and dividends are accumulated during a period so that the income statement only reflects activities for the period. In contrast, balance sheet accounts carry over from period to period. We can see this from our financial statement effects template for Apple where the bottom row balances as of September 26, 2015, become the top row in the template for the next fiscal year, which begins on September 27, 2015.

Accounting Cycle Summarized

The entire accounting process, from analysis of basic transactions to financial statement preparation to the closing process, is called the **accounting cycle**. As we discuss at the outset of this module and portray graphically in Exhibit 3.1, there are four basic processes in the accounting cycle.

1. Analyze transactions and prepare (and post) entries.
2. Prepare (and post) accounting adjustments.
3. Prepare financial statements.
4. Perform the closing process.

The analysis and posting of transactions is done regularly during each accounting period. However, the preparation of accounting adjustments and financial statements is only done at the end of an accounting period. At this point, we have explained and illustrated all aspects of the accounting cycle.

Managerial Decision ■ **You Are the Chief Financial Officer**

Assume that you learn of the leakage of hazardous waste from your company's factory. It is estimated that cleanup could cost $10 million. Part 1: What effect will recording this cost have on your company's balance sheet and its income statement? Part 2: Accounting rules require you to record this cost if it is both probable and can be reliably estimated. Although the cleanup is relatively certain, the cost is a guess at this point. Consequently, you have some discretion whether to record it. Discuss the parties that are likely affected by your decision on whether or not to record the liability and related expense and the ethical issues involved. (Answer, p. 3-19)

Review 3-5

Managerial Decision ■ You Are the Chief Financial Officer

Assume that you learn of the leakage of hazardous waste from your company's factory. It is estimated that cleanup could cost $10 million. Part 1: What effect will recording this cost have on your company's balance sheet and its income statement? Part 2: Accounting rules require you to record this cost if it is both probable and can be reliably estimated. Although the cleanup is relatively certain, the cost is a guess at this point. Consequently, you have some discretion whether to record it. Discuss the parties that are likely affected by your decision on whether or not to record the liability and related expense and the ethical issues involved. (Answer, p. 3-19)

LO5 **Review 3-5**

Refer to the information in Reviews 3-2, 3-3, and 3-4 for Prestige Inc. It has prepared its financial statements and is ready to close its books for month-end January 2017.

Guided Examples MBC

Required

Prepare the entries required to close the temporary accounts for Prestige Inc. at the end of January 2017.

Solution on p. 3-38.

Global Accounting

IFRS

The manner in which accounting data are gathered and recorded does not differ across accounting standards. Thus, the accounting cycle in Exhibit 3.1 applies in countries using IFRS in the same manner as in the United States. The difference is that companies create information systems that conform to the specific accounting rules in that country. For example, the rules for recording research and development (R&D) costs are different in the United States vis-à-vis Germany. Thus, the U.S. company and the German company would each tailor their accounting systems to properly record R&D costs so that each company's financial statements comply with their respective countries' accounting standards. The accounting cycle of each company still involves transactions and adjustments and a closing process. The result is that identical R&D expenditures are classified differently and the resulting financial statements diverge.

Large multinational companies often have subsidiaries in different countries. If a U.S. company has a foreign subsidiary, the foreign laws require a domestic set of financial statements for tax, regulatory, banking, or other purposes. For example, Apple's 2015 Form 10-K reports it has three subsidiaries incorporated in Ireland. The Irish subsidiaries must prepare IFRS financial statements to file with the Irish Revenue Commission (the Irish equivalent of the IRS). During the closing process of the accounting cycle, Apple Inc. (the U.S. parent) must consolidate the subsidiaries, which means all assets and liabilities of the subsidiaries are included on Apple Inc.'s balance sheet. Similarly, all of the revenues and expenses of the subsidiaries are included on Apple Inc.'s income statement. It would not be appropriate for a simple summing of accounts because of differences between IFRS and U.S. GAAP. Instead, Apple Inc. must convert IFRS financial statements to U.S. GAAP equivalent (as well as convert euros to U.S. dollars). To accomplish this, Apple Inc. keeps two sets of accounting records for subsidiaries, one set in GAAP and the other in IFRS. This is not as complicated as it might seem. Companies like Apple use sophisticated computer accounting systems and enterprise resource planning (ERP) systems that are capable of supporting multiple sets of accounting standards.

Appendix 3A: FASB's Financial Statement Presentation Project

Preparers and users of financial statements have long expressed concern that existing accounting standards provide too little guidance on financial statement presentation. Popular opinion is that U.S. GAAP permits too many presentation formats and is silent on specific line items and on the level of detail required in financial statements. This lack of uniformity impairs comparability across companies. For example, some companies disaggregate product costs (such as materials and labor) as well as general and administrative costs (such as rent and utilities) in their income statements, and other entities present highly aggregated product costs and general and administrative expenses. Due to these concerns, there is broad support for a FASB project on financial statement presentation.

Under current accounting standards, the statement of cash flows categorizes a company's cash flows into three categories: operating, investing, and financing. The proposal under consideration at the FASB would require similar classification on the balance sheet and the income statement. The following table illustrates the proposed sections, categories, and subcategories in each financial statement. (Summarized from "Staff Draft of an Exposure Draft JULY 2010" © IFRS Foundation and made available by the FASB [fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176164178963].)

Statement of Financial Position (Balance Sheet)	Statement of Comprehensive Income	Statement of Cash Flows

Under current accounting standards, the statement of cash flows categorizes a company's cash flows into three categories: operating, investing, and financing. The proposal under consideration at the FASB would require similar classification on the balance sheet and the income statement. The following table illustrates the proposed sections, categories, and subcategories in each financial statement. (Summarized from "Staff Draft of an Exposure Draft JULY 2010" © IFRS Foundation and made available by the FASB [fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176164178963].)

Statement of Financial Position (Balance Sheet)	Statement of Comprehensive Income	Statement of Cash Flows
Business section	**Business section**	**Business section**
Operating category	Operating category	Operating category
Operating finance subcategory	Operating finance subcategory	
Investing category	Investing category	Investing category
Financing section	**Financing section**	**Financing section**
Debt category	Debt category	
Equity category		
	Multi-category transaction section	**Multi-category transaction section**
Income tax section	**Income tax section**	**Income tax section**
Discontinued operation section	**Discontinued operation section,** net of tax	**Discontinued operation section**
	Other comprehensive income, net of tax	

The proposed presentation format is consistent with the approach we describe in Module 4—the separation of operating and nonoperating items on the income statement and balance sheet. The Module 4 approach extends the traditional DuPont analysis of return on equity (ROE) by isolating the operating activities of the business in order to evaluate what truly creates shareholder value. While the Module 4 approach sharpens our analysis of ROE, it requires additional effort at present because we must first parse operating from nonoperating components on the financial statements. Under the FASB proposal, financial statements would be formatted along these operating and nonoperating dimensions and standardized across companies. If adopted, the new format will make analysis less effortful.

Guidance Answers

You Are the Chief Financial Officer

Pg. 3-18 Part 1: Liabilities will increase by $10 million for the estimated amount of the cleanup, and an expense in that amount will be recognized in the income statement, thus reducing both income and retained earnings (equity) by $10 million. Part 2: Stakeholders affected by recognition decisions of this type are often much broader than first realized. Management is directly involved in the decision. Recording this cost can affect the market value of the company, its relations with lenders and suppliers, its auditors, and many other stakeholders. Further, if recording this cost is the right accounting decision, failure to do so can foster unethical behavior throughout the company, thus affecting additional company employees.

Questions

Q3-1. What does the term *fiscal year* mean?

Q3-2. What is the purpose of a journal?

Q3-3. Explain the process of posting.

Q3-4. What four different types of adjustments are frequently necessary before financial statements are prepared at the end of an accounting period? Give at least one example of each type.

Q3-5. On January 1, prepaid insurance was debited for $1,896 related to the cost of a two-year premium, with coverage beginning immediately. How should this account be adjusted on January 31 before financial statements are prepared for the current month?

Q3-6. At the beginning of January, the first month of the accounting year, the supplies account (asset) had a debit balance of $875. During January, purchases of $260 worth of supplies were added (debited) to the account. At the end of January, $630 of supplies were still available. How should this account be adjusted? If no adjustment is made, describe the impact on (a) the income statement for January and (b) the balance sheet prepared at January 31.

Q3-7. The publisher of *Accounting View*, a monthly magazine, received $9,768 cash on January 1 for

Q3-5. On January 1, prepaid insurance was debited for $1,896 related to the cost of a two-year premium, with coverage beginning immediately. How should this account be adjusted on January 31 before financial statements are prepared for the current month?

Q3-6. At the beginning of January, the first month of the accounting year, the supplies account (asset) had a debit balance of $875. During January, purchases of $260 worth of supplies were added (debited) to the account. At the end of January, $630 of supplies were still available. How should this account be adjusted? If no adjustment is made, describe the impact on (a) the income statement for January and (b) the balance sheet prepared at January 31.

Q3-7. The publisher of *Accounting View*, a monthly magazine, received $9,768 cash on January 1 for new subscriptions covering the next 24 months, with service beginning immediately: (*a*) Use the financial statement effects template to record the receipt of the $9,768; and (*b*) use the template to show how the accounts should be adjusted at the end of January before financial statements are prepared for the current month.

Q3-8. Refer to Q3-7. Prepare journal entries for the receipt of cash and the delivery of the magazines.

Q3-9. Trombley Travel Agency pays an employee $950 in wages each Friday for the five-day work week ending on Friday. The last Friday of January falls on January 27. How should Trombley Travel Agency adjust wages expense on January 31, its fiscal year-end?

Q3-10. The Basu Company earns interest amounting to $720 per month on its investments. The company receives the interest revenue every six months, on December 31 and June 30. Monthly financial statements are prepared. Which accounts should Basu adjust on January 31?

Q3-11. What types of accounts are closed at the end of the accounting year? What are the three major steps in the closing process?

Assignments with the logo in the margin are available in myBusinessCourse.
See the Preface of the book for details.

Mini Exercises

M3-12. Assessing Financial Statement Effects of Transactions LO2

K. Daniels started Daniels Services, a firm providing art services for advertisers, on June 1. The following accounts are needed to record the transactions for June: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, Common Stock, Dividends, Service Fees Earned, Rent Expense, Utilities Expense, and Wages Expense. Record the following transactions for June using the financial statement effects template.

June	1	K. Daniels invested $12,000 cash to begin the business in exchange for common stock.
	2	Paid $950 cash for June rent.
	3	Purchased $6,400 of office equipment on credit.
	6	Purchased $3,800 of art materials and other supplies; the company paid $1,800 cash with the remainder due within 30 days.
	11	Billed clients $4,700 for services rendered.
	17	Collected $3,250 cash from clients on their accounts billed on June 11.
	19	Paid $5,000 cash toward the account for office equipment (see June 3).
	25	Paid $900 cash for dividends.
	30	Paid $350 cash for June utilities.
	30	Paid $2,500 cash for June wages.

M3-13. Preparing Journal Entries and Posting LO2

Refer to the information in M3-12. Prepare a journal entry for each transaction. Create a T-account for each account, and then post the journal entries to the T-accounts (use dates to reference each entry).

M3-14. Assessing Financial Statement Effects of Transactions LO2

B. Fischer started Fischer Company, a cleaning services firm, on April 1. The company created the following accounts to record the transactions for April: Cash; Accounts Receivable; Supplies; Prepaid Van Lease; Equipment; Notes Payable; Accounts Payable; Common Stock; Dividends; Cleaning Fees Earned; Wages Expense; Advertising Expense; and Van Fuel Expense. Record the following transactions for April using the financial statement effects template.

April	1	B. Fischer invested $9,000 cash to begin the business in exchange for common stock.
	2	Paid $2,850 cash for six months' lease on a van for the business.
	3	Borrowed $10,000 cash from a bank and signed a note payable, agreeing to repay it in one year plus 10% interest.
	4	Purchased $5,500 in cleaning equipment; the company paid $2,500 cash with the remainder due within 30 days.
	5	Paid $4,300 cash for cleaning supplies.
	7	Paid $350 cash for advertisements to run in the area newspaper during April.
	21	Billed customers $3,500 for services performed.

April 1	B. Fischer invested $9,000 cash to begin the business in exchange for common stock.
2	Paid $2,850 cash for six months' lease on a van for the business.
3	Borrowed $10,000 cash from a bank and signed a note payable, agreeing to repay it in one year plus 10% interest.
4	Purchased $5,500 in cleaning equipment; the company paid $2,500 cash with the remainder due within 30 days.
5	Paid $4,300 cash for cleaning supplies.
7	Paid $350 cash for advertisements to run in the area newspaper during April.
21	Billed customers $3,500 for services performed.
23	Paid $3,000 cash toward the account for cleaning equipment (see April 4).
28	Collected $2,300 cash from customers on their accounts billed on April 21.
29	Paid $1,000 cash for dividends.
30	Paid $2,750 cash for April wages.
30	Paid $995 cash for gasoline used during April.

LO2 **M3-15. Preparing Journal Entries and Posting**
Refer to the information in M3-14. Prepare a journal entry for each transaction. Create a T-account for each account, and then post the journal entries to the T-accounts (use dates to reference each entry).

LO2, 3 **M3-16. Assessing Financial Statement Effects of Transactions and Adjustments**
Schrand Services offers janitorial services on both a contract basis and an hourly basis. On January 1, Schrand collected $26,100 cash in advance on a six-month contract for work to be performed evenly during the next six months.

a. Prepare the entry on January 1 to reflect the receipt of $26,100 cash for contract work; use the financial statement effects template.
b. Adjust the appropriate accounts on January 31 for the contract work done during January; use the financial statement effects template.
c. At January 31, a total of 30 hours of hourly rate janitor work was performed but unbilled. The billing rate is $19 per hour. Prepare the accounting adjustment needed on January 31 using the financial statement effects template. (The firm uses the fees receivable account to reflect revenue earned but not yet billed.)

LO2, 3 **M3-17. Preparing Accounting Adjustments**
Refer to the information in M3-16. Prepare a journal entry for each of parts *a*, *b*, and *c*.

LO3 **M3-18. Assessing Financial Statement Effects of Transactions and Adjustments**
Selected accounts of Portage Properties, a real estate management firm, are shown below as of January 31, before any accounts have been adjusted.

	Debit	Credit
Prepaid insurance	$3,240	
Supplies	1,540	
Office equipment	6,240	
Unearned rent revenue		$ 5,550
Salaries expense	2,325	
Rent revenue		13,250

Portage Properties prepares monthly financial statements. Using the following information, adjust the accounts as necessary on January 31 using the financial statement effects template.

a. Prepaid insurance represents a two-year premium paid on January 1.
b. Supplies of $710 were still available on January 31.
c. Office equipment is expected to last eight years (or 96 months).
d. Earlier this month, on January 1, Portage collected $5,550 for six months' rent in advance from a tenant renting space for $925 per month.
e. Salaries of $490 have been earned by employees but not yet recorded as of January 31.

LO3 **M3-19. Preparing Accounting Adjustments**
Refer to the information in M3-18. Prepare journal entries for each of parts *a* through *e*.

M3-20. Inferring Transactions from Financial Statements LO2 Foot Locker Inc. (FL)
Foot Locker Inc., a retailer of athletic footwear and apparel, operates 1,835 stores in the United States, Canada, Europe, Australia, and New Zealand. During its 2015 fiscal year ended in January 2016, Foot Locker purchased merchandise inventory costing $4,942 ($ millions). Assume Foot Locker makes all purchases on credit and its accounts payable is only used for inventory purchases. The following T-accounts reflect information contained in the company's fiscal 2014 and 2015 balance sheets ($ millions).

Inventories **Accounts Payable**

Auto Zoom 3-22

M3-20. Inferring Transactions from Financial Statements LO2 Foot Locker Inc. (FL)

Foot Locker Inc., a retailer of athletic footwear and apparel, operates 1,835 stores in the United States, Canada, Europe, Australia, and New Zealand. During its 2015 fiscal year ended in January 2016, Foot Locker purchased merchandise inventory costing $4,942 ($ millions). Assume Foot Locker makes all purchases on credit and its accounts payable is only used for inventory purchases. The following T-accounts reflect information contained in the company's fiscal 2014 and 2015 balance sheets ($ millions).

Inventories		
2014 Bal.	1,250	
2015 Bal.	1,285	

Accounts Payable		
	301	2014 Bal.
	279	2015 Bal.

a. Use the financial statement effects template to record Foot Locker's 2015 purchases.
b. What amount did Foot Locker pay in cash to its suppliers during fiscal year 2015? Explain.
c. Use the financial statement effects template to record cost of goods sold for its fiscal year 2015.

M3-21. Preparing Journal Entries LO2

Refer to the information in M3-20. Prepare journal entries for each of parts *a*, *b*, and *c*.

M3-22. Preparing a Statement of Stockholders' Equity LO4

On December 31, 2016, the accounts of Leuz Architect Services showed credit balances in its common stock and retained earnings accounts of $30,000 and $18,000, respectively. The company's stock issuances for 2017 totaled $6,000, and it paid $9,700 in cash dividends. During 2017, the company had net income of $27,900. Prepare a 2017 statement of stockholders' equity for Leuz Architect Services.

M3-23. Preparing Closing Journal Entries LO5 General Mills (GIS) Homework MBC

Selected financial information from General Mills as of May 29, 2016 follows.

$ millions	Debit	Credit
Net sales		$16,563.1
Cost of sales	$10,733.6	
Selling, general, and administrative expense and other	3,073.1	
Interest expense, net	303.8	
Income tax expense	755.2	
Retained earnings		11,990.8

Assume the company has not yet closed any accounts to retained earnings. Prepare journal entries to close the temporary accounts above. Set up the needed T-accounts, and post the closing entries. After these entries are posted, what is the balance of the retained earnings account?

M3-24. Inferring Transactions from Financial Statements LO2 Lowe's Companies (LOW) Homework MBC

Lowe's is the second-largest home improvement retailer in the world, with 1,857 stores. During its 2015 fiscal year ended in January 2016, Lowe's purchased merchandise inventory at a cost of $39,051 ($ millions). Assume all purchases were made on account and accounts payable is only used for inventory purchases. The following T-accounts reflect information contained in the company's 2014 and 2015 balance sheets.

Merchandise Inventories		
2014 Bal.	8,911	
2015 Bal.	9,458	

Accounts Payable		
	5,124	2014 Bal.
	5,633	2015 Bal.

a. Use the financial statement effects template to record Lowe's purchases during fiscal 2015.
b. What amount did Lowe's pay in cash to its suppliers during fiscal-year 2015? Explain.
c. Use the financial statement effects template to record cost of sales for 2015.

M3-25. Closing Process LO5

As of December 31, Hanlon Consulting's financial records contain the following selected account information.

	Debit	Credit
Service fees earned		$80,300
Rent expense	$20,800	
Salaries expense	48,700	
Supplies expense	5,600	
Depreciation expense	10,200	
Retained earnings		67,000

Prepare entries to close these accounts in journal entry form. Set up T-accounts for each account and post

	Debit	Credit
Service fees earned		$80,300
Rent expense	$20,800	
Salaries expense	48,700	
Supplies expense	5,600	
Depreciation expense	10,200	
Retained earnings		67,000

Prepare entries to close these accounts in journal entry form. Set up T-accounts for each account and post the closing entries to the T-accounts. After these entries are posted, what is the balance of the retained earnings account?

M3-26. Computing and Comparing Income and Cash Flow Measures
Penno Corporation recorded service revenues of $200,000 in 2017, of which $170,000 were on credit and $30,000 were for cash. Moreover, of the $170,000 credit sales for 2017, Penno collected $20,000 cash on those receivables before year-end 2017. The company also paid $25,000 cash for 2017 wages. Its employees also earned another $15,000 in wages for 2017, which were not yet paid at year-end 2017. (*a*) Compute the company's net income for 2017; and (*b*) how much net cash inflow or outflow did the company generate in 2017? Explain why Penno's net income and net cash flow differ.

LO3, 4 **M3-27. Analyzing Transactions to Compute Net Income**
Wasley Corp., a start-up company, provided services that were acceptable to its customers and billed those customers for $350,000 in 2016. However, Wasley collected only $280,000 cash in 2016, and the remaining $70,000 was collected in 2017. Wasley employees earned $225,000 in 2016 wages that were not paid until the first week of 2017. How much net income does Wasley report for 2016? For 2017 (assuming no additional transactions)?

LO2 **M3-28. Analyzing Transactions Using the Financial Statement Effects Template**
Report the effects for each of the following transactions using the financial statement effects template.

a. Issue stock for $1,000 cash.
b. Purchase inventory for $500 cash.
c. Sell inventory in transaction *b* for $3,000 on credit.
d. Receive $2,000 cash toward transaction *c* receivable.

Exercises

LO2, 3 **E3-29. Assessing Financial Statement Effects of Adjustments**
For each of the following separate situations, prepare the necessary accounting adjustments using the financial statement effects template.

Homework MBC

a. Unrecorded depreciation on equipment is $720.
b. The supplies account has a balance of $3,870. Supplies still available at the end of the period total $1,100.
c. On the date for preparing financial statements, an estimated utilities expense of $430 has been incurred, but no utility bill has yet been received or paid.
d. On the first day of the current period, rent for four periods was paid and recorded as a $3,200 increase (debit) to prepaid rent and a $3,200 decrease (credit) to cash.
e. Nine months ago, a one-year service policy was sold to a customer, and the seller recorded the cash received by crediting unearned revenue for $1,872. No accounting adjustments have been prepared during the nine-month period. The seller is now preparing annual financial statements.
f. At the end of the period, employee wages of $965 have been incurred but not paid or recorded.
g. At the end of the period, $300 of interest has been earned but not yet received or recorded.

LO2, 3 **E3-30. Preparing Accounting Adjustments**
Refer to the information in E3-29. Prepare journal entries for each accounting adjustment.

E3-31. Assessing Financial Statement Effects of Adjustments Across Two Periods LO3
Oakmont Company closes its accounts on December 31 each year. The company works a five-day work week and pays its employees every two weeks. On December 31, Oakmont accrued $4,700 of salaries payable. On January 9 of the following year, the company paid salaries of $15,000 cash to employees. Prepare entries using the financial statement effects template to (*a*) accrue the salaries payable on December 31, and (*b*) record the salary payment nine days later on January 9.

E3-32. Preparing Accounting Adjustments LO3, 5
Refer to the information in E3-31. Prepare journal entries to accrue the salaries in December, close salaries expense for the year, and pay the salaries in January of the following year. Assume there is no

E3-31. Assessing Financial Statement Effects of Adjustments Across Two Periods LO3

Oakmont Company closes its accounts on December 31 each year. The company works a five-day work week and pays its employees every two weeks. On December 31, Oakmont accrued $4,700 of salaries payable. On January 9 of the following year, the company paid salaries of $15,000 cash to employees. Prepare entries using the financial statement effects template to (*a*) accrue the salaries payable on December 31, and (*b*) record the salary payment nine days later on January 9.

E3-32. Preparing Accounting Adjustments LO3, 5

Refer to the information in E3-31. Prepare journal entries to accrue the salaries in December, close salaries expense for the year, and pay the salaries in January of the following year. Assume there is no change in the pay rate during the year and no change in the company's work force.

E3-33. Financial Analysis Using Adjusted Account Data LO3

Homework MBC

Selected T-account balances for Bloomfield Company are shown below as of January 31, which reflect its accounting adjustments. The firm uses a calendar-year accounting period but prepares *monthly* accounting adjustments.

Supplies			
Jan. 31 Bal.	900		

Supplies Expense			
Jan. 31 Bal.	960		

Prepaid Insurance			
Jan. 31 Bal.	574		

Insurance Expense			
Jan. 31 Bal.	82		

Wages Payable			
		700	Jan. 31 Bal.

Wages Expense			
Jan. 31 Bal.	3,200		

Truck			
Jan. 31 Bal.	8,700		

Accumulated Depreciation—Truck			
		2,610	Jan. 31 Bal.

a. If the amount in supplies expense represents the January 31 adjustment for the supplies used in January, and $620 worth of supplies were purchased during January, what was the January 1 beginning balance of supplies?
b. The amount in the insurance expense account represents the adjustment made at January 31 for January insurance expense. If the original insurance premium was for one year, what was the amount of the premium, and on what date did the insurance policy start?
c. If we assume that no beginning balance existed in either wages payable or wages expense on January 1, how much cash was paid as wages during January?
d. If the truck has a useful life of five years (or 60 months), what is the monthly amount of depreciation expense, and how many months has Bloomfield owned the truck?

E3-34. Assessing Financial Statement Effects of Adjustments LO3

L. Burnett began Burnett Refinishing Service on July 1. Selected accounts are shown below as of July 31, before any accounting adjustments have been made.

	Debit	Credit
Prepaid rent	$6,900	
Prepaid advertising	630	
Supplies	3,000	
Unearned refinishing fees		$ 600
Refinishing fees revenue		2,500

Using the following information, prepare the accounting adjustments necessary on July 31 using the financial statement effects template.

a. On July 1, the firm paid one year's rent of $6,900 in cash.
b. On July 1, $630 cash was paid to the local newspaper for an advertisement to run daily for the months of July, August, and September.

c. Supplies still available at July 31 total $1,100.
d. At July 31, refinishing services of $800 have been performed but not yet recorded or billed to customers. The firm uses the fees receivable account to reflect amounts due but not yet billed.
e. In early July, a customer paid $600 in advance for a refinishing project. At July 31, the project is one-half complete.

LO3 **E3-35. Preparing Accounting Adjustments and Posting**

Refer to the information in E3-34. Prepare adjusting journal entries for each transaction. Set up T-accounts for each of the ledger accounts, and post the journal entries to them.

c. Supplies still available at July 31 total $1,100.
d. At July 31, refinishing services of $800 have been performed but not yet recorded or billed to customers. The firm uses the fees receivable account to reflect amounts due but not yet billed.
e. In early July, a customer paid $600 in advance for a refinishing project. At July 31, the project is one-half complete.

LO3 **E3-35. Preparing Accounting Adjustments and Posting**
Refer to the information in E3-34. Prepare adjusting journal entries for each transaction. Set up T-accounts for each of the ledger accounts, and post the journal entries to them.

LO2 The Gap Inc. (GPS) Homework MBC
E3-36. Inferring Transactions from Financial Statements
The GAP is a global clothing retailer for men, women, children, and babies. The following information is taken from The Gap's fiscal 2015 annual report.

Selected Balance Sheet Data ($ millions)	2015	2014
Inventories	$1,873	$1,889
Accounts Payable	1,112	1,173

a. The Gap purchased inventories totaling $10,061 million during fiscal 2015. Use the financial statement effects template to record cost of goods sold for The Gap's fiscal year ended 2015. (Assume accounts payable is used only for recording purchases of inventories and all inventories are purchased on credit.)
b. What amount did the company pay to suppliers during the year? Record this with the financial statement effects template.

LO2 The GAP Inc. (GPS)
E3-37. Inferring Transactions and Preparing Journal Entries
Refer to the information in E3-36. Prepare journal entries for each transaction.

LO5 The GAP Inc. (GPS)
E3-38. Preparing Closing Journal Entries
The GAP Inc.'s fiscal 2015 financial statements provide the balances for the following selected accounts.

$ millions	Debit	Credit
Net sales		$15,797
Cost of goods sold	$10,077	
Operating expenses (other than COGS)	4,196	
Interest expense, net	53	
Income tax expense	551	
Retained earnings (beginning of year)		2,797

Prepare entries to close these accounts in journal entry form. Set up T-accounts for each of the accounts, and post the entries to them. After these entries are posted, what is the balance of the retained earnings account?

LO2 Costco Wholesale Corporation (COST) Homework MBC
E3-39. Inferring Transactions from Financial Statements
Costco Wholesale Corporation operates membership warehouses selling food, appliances, consumer electronics, apparel, and other household goods at 721 locations across the United States as well as in Canada, the United Kingdom, Japan, Australia, South Korea, Taiwan, Mexico, and Puerto Rico. As of its fiscal year-end 2016, Costco had approximately 86.7 million members. Selected fiscal-year information from the company's balance sheets follows.

Selected Balance Sheet Data ($ millions)	2016	2015
Merchandise inventories	$8,969	$8,908
Deferred membership income (liability)	1,362	1,269

a. During fiscal 2016, Costco collected $2,739 million cash for membership fees. Use the financial statement effects template to record the cash collected for membership fees.
b. Costco recorded merchandise costs (i.e., cost of goods sold) of $102,901 million in 2016. Record this transaction in the financial statement effects template.
c. Determine the value of merchandise Costco purchased during 2016. Use the financial statement effects template to record these merchandise purchases. Assume all of Costco's purchases are on credit.

E3-40. Inferring Transactions and Preparing Journal Entries LO2 Costco Wholesale Corporation (COST)
Refer to the information in E3-39. Prepare journal entries for transactions in parts *a* through *c*.

E3-41. Preparing Financial Statements and Closing Process LO4, 5 Homework MBC
Beneish Company has the following account balances at December 31, the end of its fiscal year.

	Debit	Credit
Cash	$ 8,000	
Accounts receivable	6,500	

E3-40. Inferring Transactions and Preparing Journal Entries
Refer to the information in E3-39. Prepare journal entries for transactions in parts *a* through *c*.

LO2
Costco Wholesale Corporation (COST)

E3-41. Preparing Financial Statements and Closing Process
Beneish Company has the following account balances at December 31, the end of its fiscal year.

LO4, 5

	Debit	Credit
Cash	$ 8,000	
Accounts receivable	6,500	
Equipment	78,000	
Accumulated depreciation		$ 14,000
Notes payable		10,000
Common stock		43,000
Retained earnings		20,600
Dividends	8,000	
Service fees earned		75,000
Rent expense	18,000	
Salaries expense	37,100	
Depreciation expense	7,000	
Totals	$162,600	$162,600

a. Prepare Beneish Corporation's income statement and statement of stockholders' equity for year-end December 31 and its balance sheet as of December 31. The company paid cash dividends of $8,000, and there were no stock issuances or repurchases during the year.
b. Prepare journal entries to close Beneish's temporary accounts.
c. Set up T-accounts for each account and post the closing entries.

E3-42. Analyzing and Reporting Financial Statement Effects of Transactions
M. E. Carter launched Carter Company, a professional services firm on March 1. The firm will prepare financial statements at each month-end. In March (its first month), Carter executed the following transactions. Enter the transactions, *a* through *g*, into the financial statement effects template shown in the module.

LO2

a. Carter (owner) invested in the company $100,000 cash and $20,000 in property and equipment. The company issued common stock to Carter.
b. The company paid $3,200 cash for rent of office furnishings and facilities for March.
c. The company performed services for clients and immediately received $4,000 cash earned.
d. The company performed services for clients and sent a bill for $24,000 with payment due within 60 days.
e. The company compensated an office employee with $4,800 cash as salary for March.
f. The company received $10,000 cash as partial payment on the amount owed from clients in transaction *d*.
g. The company paid $935 cash in dividends to Carter (owner).

E3-43. Analyzing Transactions Using the Financial Statement Effects Template
Refer to transactions *a* through *g* from E3-42. Prepare an income statement for Carter Company for the month of March.

LO4

E3-44. Analyzing Transactions Using the Financial Statement Effects Template
Record the effect of each of the following transactions for Hora Company using the financial statement effects template.

LO2

a. Wages of $500 are earned by employees but not yet paid.
b. $2,000 of inventory is purchased on credit.
c. Inventory purchased in transaction *b* is sold for $4,000 on credit.
d. Collected $3,000 cash from transaction *c*.
e. Equipment is acquired for $5,000 cash.
f. Recorded $1,000 depreciation expense on equipment from transaction *e*.
g. Paid $10,000 cash toward a note payable that came due.
h. Paid $2,000 cash for interest on borrowings.

Problems

LO2, 3 **P3-45. Assessing Financial Statement Effects of Transactions and Adjustments**
The following information relates to December 31 accounting adjustments for Fulton Fast Print Company. The firm's fiscal year ends on December 31.

1. Weekly salaries for a five-day week total $3,600, payable on Fridays. December 31 of the current year is a Tuesday.
2. Fulton Fast Print has $20,000 of notes payable outstanding at December 31. Interest of $200 has

Problems

LO2, 3 P3-45. Assessing Financial Statement Effects of Transactions and Adjustments

The following information relates to December 31 accounting adjustments for Fulton Fast Print Company. The firm's fiscal year ends on December 31.

1. Weekly salaries for a five-day week total $3,600, payable on Fridays. December 31 of the current year is a Tuesday.
2. Fulton Fast Print has $20,000 of notes payable outstanding at December 31. Interest of $200 has accrued on these notes by December 31 but will not be paid until the notes mature next year.
3. During December, Fulton Fast Print provided $900 of printing services to clients who will be billed on January 2. The firm uses the fees receivable account to reflect amounts earned but not yet billed.
4. Starting December 1, all maintenance work on Fulton Fast Print's equipment is handled by Richardson Repair Company under an agreement whereby Fulton Fast Print pays a fixed monthly charge of $400. Fulton Fast Print paid six months' service charge of $2,400 cash in advance on December 1 and increased its Prepaid maintenance account by $2,400.
5. The firm paid $900 cash on December 15 for a series of radio commercials to run during December and January. One-third of the commercials aired by December 31. The $900 payment was recorded in its prepaid advertising account.
6. Starting December 16, Fulton Fast Print rented 800 square feet of storage space from a neighboring business. The monthly rent of $0.80 per square foot is due in advance on the first of each month. Nothing was paid in December, however, because the neighboring business agreed to add the rent for one-half of December to the January 1 payment.
7. Fulton Fast Print invested $5,000 cash in securities on December 1 and earned interest of $38 on these securities by December 31. No interest will be received until January.
8. Annual depreciation on the firm's equipment is $2,175. No depreciation has been recorded during the year.

Required

Prepare Fulton Fast Print Company's accounting adjustments required at December 31 using the financial statement effects template.

LO2, 3 P3-46. Preparing Accounting Adjustments

Refer to the information in P3-45. Prepare accounting adjustments required at December 31 using journal entries.

LO2, 3 P3-47. Assessing Financial Statement Effects of Adjustments Across Two Periods

Sloan Company has the following account balances at December 31, the end of its fiscal year (all accounts have normal balances).

Prepaid advertising	$ 1,200	Unearned service fees	$ 5,400
Wages expense	43,800	Service fees earned	87,000
Prepaid insurance	3,420	Rental income	4,900

Required

a. Prepare Sloan Company's accounting adjustments at December 31 using the financial statement effects template and the following additional information.
   1. Prepaid advertising at December 31 is $800.
   2. Unpaid wages earned by employees in December are $2,600.
   3. Prepaid insurance at December 31 is $2,280.
   4. Unearned service fees at December 31 are $3,000.
   5. Rent revenue of $1,000 owed by a tenant is not recorded at December 31.

b. Use the financial statement effects template to record the following transactions on January 4 of the following year:
   1. Payment of $4,800 cash in wages.
   2. Cash receipt from the tenant of the $1,000 rent revenue.

LO2, 3 P3-48. Preparing Accounting Adjustments

Refer to the information in P3-47. Prepare journal entries for parts *a* and *b*.

P3-49. Journalizing and Posting Transactions and Adjustments **LO2, 3**

D. Roulstone opened Roulstone Roofing Service on April 1. Transactions for April follow.

Apr.	1	Roulstone contributed $11,500 cash to the business in exchange for common stock.
	2	Paid $6,100 cash for the purchase of a used truck.
	2	Purchased $6,200 of ladders and other equipment; the company paid $1,000 cash, with the balance due in 30 days.
	3	Paid $2,880 cash for a two-year (or 24-month) premium toward liability insurance.
	5	Purchased $1,200 of supplies on credit.
	5	Received an advance of $1,800 cash from a customer for roof repairs to be done during

P3-49. Journalizing and Posting Transactions and Adjustments LO2, 3

D. Roulstone opened Roulstone Roofing Service on April 1. Transactions for April follow.

Apr.	1	Roulstone contributed $11,500 cash to the business in exchange for common stock.
	2	Paid $6,100 cash for the purchase of a used truck.
	2	Purchased $6,200 of ladders and other equipment; the company paid $1,000 cash, with the balance due in 30 days.
	3	Paid $2,880 cash for a two-year (or 24-month) premium toward liability insurance.
	5	Purchased $1,200 of supplies on credit.
	5	Received an advance of $1,800 cash from a customer for roof repairs to be done during April and May.
	12	Billed customers $5,500 for roofing services performed.
	18	Collected $4,900 cash from customers toward their accounts billed on April 12.
	29	Paid $675 cash for truck fuel used in April.
	30	Paid $100 cash for April newspaper advertising.
	30	Paid $4,500 cash for assistants' wages earned.
	30	Billed customers $4,000 for roofing services performed.

Required

a. Set up T-accounts for the following accounts: cash, accounts receivable, supplies, prepaid insurance, trucks, accumulated depreciation—trucks, equipment, accumulated depreciation—equipment, accounts payable, unearned roofing fees, common stock, roofing fees earned, fuel expense, advertising expense, wages expense, insurance expense, supplies expense, depreciation expense—trucks, and depreciation expense—equipment.

b. Record these transactions for April using journal entries.

c. Post the journal entries from part *b.* to their T-accounts (reference transactions in T-accounts by date).

d. Prepare journal entries to adjust the following accounts: insurance expense, supplies expense, depreciation expense—trucks, depreciation expense—equipment, and roofing fees earned. Supplies still available on April 30 amount to $200. Depreciation for April was $125 on the truck and $35 on equipment. One-fourth of the roofing fee received on April 5 was earned by April 30.

e. Post the adjusting journal entries from part *d.* to their T-accounts.

P3-50. Assessing Financial Statement Effects of Transactions and Adjustments LO2, 3

Refer to the information in P3-49.

Required

a. Use the financial statement effects template to record the transactions for April.

b. Use the financial statement effects template to record the adjustments at the end of April (described in part *d* of P3-49).

P3-51. Preparing Accounting Adjustments LO3

Pownall Photomake Company, a commercial photography studio, completed its first year of operations on December 31. Account balances before year-end adjustments follow; no adjustments have been made to the accounts at any time during the year. Assume that all balances are normal.

Cash	$ 4,300	Accounts payable	$ 4,060
Accounts receivable	3,800	Unearned photography fees	2,600
Prepaid rent	12,600	Common stock	24,000
Prepaid insurance	2,970	Photography fees earned	34,480
Supplies	4,250	Wages expense	11,000
Equipment	22,800	Utilities expense	3,420

An analysis of the firm's records discloses the following (business began on January 1).

1. Photography services of $1,850 have been rendered, but customers have not yet paid or been billed. The company uses the fees receivable account to reflect amounts due but not yet billed.
2. Equipment, purchased January 1, has an estimated life of 10 years.
3. Utilities expense for December is estimated to be $400, but the bill will not arrive or be paid until January of next year. (All prior months' utilities bills have been received and paid.)
4. The balance in prepaid rent represents the amount paid on January 1 for a two-year lease on the studio it operates from.

5. In November, customers paid $2,600 cash in advance for photos to be taken for the holiday season. When received, these fees were credited to unearned photography fees. By December 31, all of these fees are earned.
6. A three-year insurance premium paid on January 1 was debited to prepaid insurance.
7. Supplies still available at December 31 are $1,020.
8. At December 31, wages expense of $375 had been incurred but not yet paid or recorded.

Required

Prepare the required adjusting entries using the financial statement effects template.

5. In November, customers paid $2,600 cash in advance for photos to be taken for the holiday season. When received, these fees were credited to unearned photography fees. By December 31, all of these fees are earned.
6. A three-year insurance premium paid on January 1 was debited to prepaid insurance.
7. Supplies still available at December 31 are $1,020.
8. At December 31, wages expense of $375 had been incurred but not yet paid or recorded.

Required
Prepare the required adjusting entries using the financial statement effects template.

LO3 **P3-52. Recording Adjustments with Journal Entries and T-Accounts**
Refer to the information in P3-51.

Required
a. Prepare journal entries to record the accounting adjustments.
b. Set up T-accounts for each account, and post the journal entries to them.

LO3 **P3-53. Preparing Accounting Adjustments**
BensEx, a mailing service, has just completed its first year of operations on December 31. Its account balances before year-end adjustments follow; no adjusting entries have been made to the accounts at any time during the year. Assume all balances are normal.

Cash	$ 1,700	Accounts payable	$ 2,700
Accounts receivable	5,120	Common stock	9,530
Prepaid advertising	1,680	Mailing fees earned	86,000
Supplies	6,270	Wages expense	38,800
Equipment	42,240	Rent expense	6,900
Notes payable	7,500	Utilities expense	3,020

An analysis of the firm's records reveals the following (business began on January 1).

1. The balance in prepaid advertising represents the amount paid for newspaper advertising for one year. The agreement, which calls for the same amount of space each month, covers the period from February 1 of this first year to January 31 of the following year. BensEx did not advertise during its first month of operations.
2. Equipment, purchased January 1, has an estimated life of eight years.
3. Utilities expense does not include expense for December, estimated at $325. The bill will not arrive until January of the following year.
4. At year-end, employees have earned $2,400 in wages that will not be paid until January.
5. Supplies available at year-end amount to $1,520.
6. At year-end, unpaid interest of $450 has accrued on the notes payable.
7. The firm's lease calls for rent of $575 per month payable on the first of each month, plus an amount equal to 0.75% of annual mailing fees earned. The rental percentage is payable within 15 days after the end of the year.

Required
Prepare its adjusting entries using the financial statement effects template.

LO3 **P3-54. Recording Accounting Adjustments with Journal Entries and T-Accounts**
Refer to information in P3-53.

Required
a. Prepare journal entries to record the accounting adjustments.
b. Set up T-accounts for each account, and post the journal entries to them.

LO3, 4, 5 **P3-55. Preparing Accounting Adjustments**
Wysocki Wheels began operations on March 1 to provide automotive wheel alignment and balancing services. On March 31, accounting records revealed the following account balances.

	Debit	Credit
Cash	$ 2,900	
Accounts receivable	3,820	
Prepaid rent	4,770	
Supplies	3,700	
Equipment	36,180	
Accounts payable		$ 3,510
Unearned service revenue		1,000

	Debit	Credit
Cash	$ 2,900	
Accounts receivable	3,820	
Prepaid rent	4,770	
Supplies	3,700	
Equipment	36,180	
Accounts payable		$ 3,510
Unearned service revenue		1,000
Common stock		38,400
Service revenue		12,360
Wages expense	3,900	
	$55,270	$55,270

The following information is also available.

1. The balance in prepaid rent was the amount paid on March 1 to cover the first six months' rent.
2. Supplies available on March 31 amounted to $1,360.
3. Equipment has an estimated life of nine years (or 108 months).
4. Unpaid and unrecorded wages at March 31 were $1,560.
5. Utility services used during March were estimated at $390; a bill is expected early in April.
6. The balance in unearned service revenue was the amount received on March 1 from a car dealer to cover alignment and balancing services on cars sold by the dealer in March and April. Wysocki Wheels agreed to provide the services at a fixed fee of $500 each month.

Required

a. Prepare its accounting adjustments at March 31 in journal entry form.
b. Set up T-accounts, and post the accounting adjustments to them.
c. Prepare its income statement for March and its balance sheet at March 31.
d. Prepare entries to close its temporary accounts in journal entry form. Post the closing entries to the T-accounts.

P3-56. Analyzing Transactions Using the Financial Statement Effects Template LO2, 4

Sefcik Company began operations on the first of October. Following are the transactions for its first month of business.

1. S. Sefcik launched Sefcik Company and invested $50,000 into the business in exchange for common stock. The company also borrowed $100,000 from a local bank.
2. Sefcik Company purchased equipment for $95,000 cash and inventory of $40,000 on credit (the company still owes its suppliers for the inventory at month-end).
3. Sefcik Company sold inventory costing $30,000 for $50,000 cash.
4. Sefcik Company paid $12,000 cash for wages owed employees for October work.
5. Sefcik Company paid interest on the bank loan of $1,000 cash.
6. Sefcik Company recorded $500 of depreciation expense related to its equipment.
7. Sefcik Company paid a dividend of $2,000 cash.

Required

a. Record the effects of each transaction using the financial statement effects template.
b. Prepare the income statement and balance sheet at the end of October.

P3-57. Analyzing Transactions Using the Financial Statement Effects Template LO2, 3

Following are selected transactions of Mogg Company. Record the effects of each using the financial statement effects template.

1. Shareholders contribute $10,000 cash to the business in exchange for common stock.
2. Employees earn $500 in wages that have not been paid at period-end.
3. Inventory of $3,000 is purchased on credit.
4. The inventory purchased in transaction 3 is sold for $4,500 on credit.
5. The company collected the $4,500 owed to it per transaction 4.
6. Equipment is purchased for $5,000 cash.
7. Depreciation of $1,000 is recorded on the equipment from transaction 6.
8. The supplies account had a $3,800 balance at the beginning of this period; a physical count at period-end shows that $800 of supplies are still available. No supplies were purchased during this period.

9. The company paid $12,000 cash toward the principal on a note payable; also, $500 cash is paid to cover this note's interest expense for the period.
10. The company received $8,000 cash in advance for services to be delivered next period.

LO2, 3, 4 **P3-58. Analyzing Transactions Using the Financial Statement Effects Template**

On March 1, S. Penman launched AniFoods Inc., an organic foods retailing company. Following are the transactions for its first month of business.

1. S. Penman contributed $100,000 cash to the company in return for common stock. Penman also lent the company $55,000. This $55,000 note is due one year hence.
2. The company purchased equipment in the amount of $50,000, paying $10,000 cash and signing a

Auto Zoom 3-31

9. The company paid $12,000 cash toward the principal on a note payable; also, $500 cash is paid to cover this note's interest expense for the period.
10. The company received $8,000 cash in advance for services to be delivered next period.

LO2, 3, 4 **P3-58. Analyzing Transactions Using the Financial Statement Effects Template**
On March 1, S. Penman launched AniFoods Inc., an organic foods retailing company. Following are the transactions for its first month of business.

1. S. Penman contributed $100,000 cash to the company in return for common stock. Penman also lent the company $55,000. This $55,000 note is due one year hence.
2. The company purchased equipment in the amount of $50,000, paying $10,000 cash and signing a note payable to the equipment manufacturer for the remaining balance.
3. The company purchased inventory for $80,000 cash in March.
4. The company had March sales of $100,000, of which $60,000 was for cash and $40,000 on credit. Total cost of goods sold for its March sales was $70,000.
5. The company purchased advertising time from a local radio station for $10,000 cash.
6. During March, $7,500 worth of radio spots purchased in transaction 5 are aired. The remaining spots will be aired in April.
7. Employee wages earned and paid during March total $17,000 cash.
8. Prior to disclosing the financial statements, the company recognized that employees had earned an additional $1,000 in wages that will be paid in the next period.
9. The company recorded $2,000 of depreciation for March relating to its equipment.

Required

a. Record the effect of each transaction using the financial statement effects template.
b. Prepare a March income statement and a balance sheet as of the end of March for AniFoods Inc.

LO2, 4 **P3-59. Analyzing Transactions Using the Financial Statement Effects Template**
Hanlon Advertising Company began the current month with the following balance sheet.

Homework MBC

Cash	$ 80,000	Liabilities	$ 70,000
Noncash assets	135,000	Contributed capital	110,000
		Earned capital	35,000
Total assets	$215,000	Total liabilities and equity	$215,000

Following are summary transactions that occurred during the current month.

1. The company purchased supplies for $5,000 cash; none were used this month.
2. Services of $2,500 were performed this month on credit.
3. Services were performed for $10,000 cash this month.
4. The company purchased advertising for $8,000 cash; the ads will run next month.
5. The company received $1,200 cash as partial payment on accounts receivable from transaction 2.
6. The company paid $3,400 cash toward the accounts payable balance reported at the beginning of the month.
7. The company paid $3,500 cash toward this month's wages expenses.
8. The company declared and paid dividends of $500 cash.

Required

a. Record the effects of each transaction using the financial statement effects template.
b. Prepare the income statement for this month and the balance sheet as of month-end.

LO2, 3, 4 **P3-60. Analyzing Transactions Using the Financial Statement Effects Template**
Werner Realty Company began the month with the following balance sheet.

Cash	$ 30,000	Liabilities	$ 90,000
Noncash assets	225,000	Contributed capital	45,000
		Earned capital	120,000
Total assets	$255,000	Total liabilities and equity	$255,000

Following are summary transactions that occurred during the current month.

1. The company purchased $6,000 of supplies on credit.
2. The company received $8,000 cash from a new customer for services to be performed next month.

3. The company paid $6,000 cash to cover office rent for two months (the current month and the next).
4. The company billed clients for $25,000 of work performed.
5. The company paid employees $6,000 cash for work performed.
6. The company collected $25,000 cash from accounts receivable in transaction 4.
7. The company recorded $4,000 depreciation on its equipment.
8. At month-end, $2,000 of supplies purchased in transaction 1 are still available; no supplies were available when the month began.

Required

a. Record the effects of each transaction using the financial statement effects template.

3. The company paid $6,000 cash to cover office rent for two months (the current month and the next).
4. The company billed clients for $25,000 of work performed.
5. The company paid employees $6,000 cash for work performed.
6. The company collected $25,000 cash from accounts receivable in transaction 4.
7. The company recorded $4,000 depreciation on its equipment.
8. At month-end, $2,000 of supplies purchased in transaction 1 are still available; no supplies were available when the month began.

Required

a. Record the effects of each transaction using the financial statement effects template.
b. Prepare the income statement for this month and the balance sheet as of month-end.

IFRS Applications

I3-61. Preparing Closing Journal Entries — LO5, Qantas Airlines

On June 30, 2016, Qantas Airlines reports the following balances:

AUD millions	Debit	Credit
Total passenger and freight revenue		16,200
Manpower and staff related	3,849	
Fuel	3,250	
Aircraft operating variable	3,362	
Depreciation and amortisation	1,224	
Other expenses	2,872	
Finance costs	219	
Income tax expense	395	
Retained earnings (deficit)	1,115	

Assume the company has not yet closed any accounts to retained earnings. Prepare journal entries to close the temporary accounts above. Set up the needed T-accounts, and post the closing entries. After these entries are posted, what is the balance of the retained earnings account?

I3-62. Inferring Transactions from Financial Statements — LO2, Rio Tinto

Rio Tinto is a British-Australian multinational metals and mining corporation with headquarters in London, England, and a management office in Melbourne, Australia. Assume the following amounts have not been recorded ($ millions).

Sales revenue	$34,829
Depreciation and amortization expense	4,645
Income taxes paid	1,792

Use the financial statement effects template to record the following transactions for Rio Tinto for fiscal 2015.

a. Sales revenue. Assume 100% of the company's revenue is credit sales (i.e., sales are on accounts receivable).
b. Depreciation expense.
c. Income taxes paid. Assume this represents the portion of income tax expense paid in cash.

I3-63. Inferring Transactions and Account Balances from Financial Statements — LO2, Canadian Tire Corp.

Canadian Tire Corporation is a Canadian firm whose core operation is Canadian Tire, a retail and automotive services operation. Its head office is in Toronto, Ontario. The following T-accounts reflect information in the company's 2014 and 2015 balance sheets (in millions of Canadian dollars).

Inventories		
2014 Balance	1,623.8	
2015 Balance	1,764.5	

Accounts Payable		
	1,961.2	2014 Balance
	1,957.1	2015 Balance

Required

a. Use the financial statement effects template to record Canadian Tire's purchases during fiscal 2015. Assume Canadian Tire incurred cost of goods sold (which the company labels "Cost of producing revenue") of $8,144.3 million during 2015.
b. What amount did Canadian Tire pay in cash to its suppliers during fiscal 2015? Explain. Assume all inventory purchases are made on account and accounts payable reflects only inventory purchases.
c. Use the financial statement effects template to record cost of goods sold for fiscal 2015.

Required

a. Use the financial statement effects template to record Canadian Tire's purchases during fiscal 2015. Assume Canadian Tire incurred cost of goods sold (which the company labels "Cost of producing revenue") of $8,144.3 million during 2015.

b. What amount did Canadian Tire pay in cash to its suppliers during fiscal 2015? Explain. Assume all inventory purchases are made on account and accounts payable reflects only inventory purchases.

c. Use the financial statement effects template to record cost of goods sold for fiscal 2015.

Management Applications

LO3, 4 **MA3-64. Preparing Accounting Adjustments and Financial Statements**

Stocken Surf Shop began operations on July 1 with an initial investment of $50,000. During the first three months of operations, the following cash transactions were recorded in the firm's checking account.

Deposits		Checks Drawn	
Initial investment by owner	$ 50,000	Rent	$ 24,000
Collected from customers	81,000	Fixtures and equipment	25,000
Borrowings from bank	10,000	Merchandise inventory	62,000
	$141,000	Salaries	8,000
		Other expenses	13,000
			$132,000

Additional information:

1. Most sales were for cash; however, the store accepted a limited amount of credit sales; at September 30, customers owed the store $9,000.
2. Rent was paid on July 1 for six months.
3. Salaries of $4,000 per month were paid on the first of each month for salaries earned in the month prior.
4. Inventories were purchased for cash; at September 30, inventory of $28,000 was still available.
5. Fixtures and equipment were expected to last five years (or 60 months), with zero salvage value.
6. The bank charges 12% annual interest (1% per month) on the $10,000 bank loan. Stocken took out the loan on July 1.

Required

a. Record all of Stocken's cash transactions, and prepare any necessary adjusting entries at September 30. You may either use the financial statement effects template or journal entries combined with T-accounts.

b. Prepare the income statement for the three months ended September 30 and the balance sheet at September 30.

c. Analyze the statements from part *b*, and assess the company's performance over its initial three months.

LO3 **MA3-65. Analyzing Transactions, Impacts on Financial Ratios, and Loan Covenants**

Kadous Consulting, a firm started three years ago by K. Kadous, offers consulting services for material handling and plant layout. Its balance sheet at the close of the current year follows.

KADOUS CONSULTING
Balance Sheet
December 31

Assets		Liabilities	
Cash	$ 3,400	Notes payable	$30,000
Accounts receivable	20,875	Accounts payable	4,200
Supplies	13,200	Unearned consulting fees	11,300
Prepaid insurance	6,500	Wages payable	400
Equipment, gross	68,500	Total liabilities	[illegible]

KADOUS CONSULTING
Balance Sheet
December 31

Assets		Liabilities	
Cash	$ 3,400	Notes payable	$30,000
Accounts receivable	20,875	Accounts payable	4,200
Supplies	13,200	Unearned consulting fees	11,300
Prepaid insurance	6,500	Wages payable	400
Equipment, gross	68,500	Total liabilities	45,900
Less: Accumulated depreciation	23,975	**Equity**	
		Common stock	8,000
Equipment, net	44,525	Retained earnings	34,600
Total assets	$88,500	Total liabilities and equity	$88,500

Earlier in the year, Kadous obtained a bank loan of $30,000 cash for the firm. A provision of the loan is that the year-end debt-to-equity ratio (total liabilities to total equity) cannot exceed 1.0. Based on the above balance sheet, the ratio at December 31 of this year is 1.08. Kadous is concerned about being in violation of the loan agreement and requests assistance in reviewing the situation. Kadous believes she might have overlooked some items at year-end. Discussions with Kadous reveal the following.

1. On January 1 of this year, the firm paid a $6,500 insurance premium for two years of coverage; the amount in prepaid insurance has not yet been adjusted.
2. Depreciation on equipment should be 10% of cost per year; the company inadvertently recorded 15% for this year.
3. Interest on the bank loan has been paid through the end of this year.
4. The firm concluded a major consulting engagement in December, doing a plant layout analysis for a new factory. The $8,000 fee has not been billed or recorded in the accounts.
5. On December 1 of this year, the firm received an $11,300 cash advance payment from Dichev Corp. for consulting services to be rendered over a two-month period. This payment was credited to the unearned consulting fees account. One-half of this fee was earned but unrecorded by December 31 of this year.
6. Supplies costing $4,800 were available on December 31; the company has made no adjustment of its Supplies account.

Required

a. What is the correct debt-to-equity ratio at December 31?
b. Is the firm in violation of its loan agreement? Prepare computations to support the correct total liabilities and total equity figures at December 31.

MA3-66. Ethics, Accounting Adjustments, and Auditors LO3

It is the end of the accounting year for Anne Beatty, controller of a medium-sized, publicly held corporation specializing in toxic waste cleanup. Within the corporation, only Beatty and the president know the firm has been negotiating for several months to land a large contract for waste cleanup in Western Europe. The president has hired another firm with excellent contacts in Western Europe to help with negotiations. The outside firm will charge an hourly fee plus expenses but has agreed not to submit a bill until the negotiations are in their final stages (expected to occur in another three to four months). Even if the contract falls through, the outside firm is entitled to receive payment for its services. Based on her discussion with a member of the outside firm, Beatty knows its charge for services provided to date will be $150,000. This is a material amount for the company.

Beatty knows the president wants negotiations to remain as secret as possible so competitors will not learn of the contract the company is pursuing in Europe. In fact, the president recently stated to her, "This is not the time to reveal our actions in Western Europe to other staff members, our auditors, or the readers of our financial statements; securing this contract is crucial to our future growth." No entry has been made in the accounting records for the cost of contract negotiations. Beatty now faces an uncomfortable situation. The company's outside auditor has just asked her if she knows of any year-end adjustments that have not yet been recorded.

Required

a. What are the ethical considerations Beatty faces in answering the auditor's question?
b. How should Beatty respond to the auditor's question?

Solutions to Review Problems

Review 3-1—Solution

	Cash Asset	Noncash Asset	Liabilities	Contributed Capital	Earned Capital	Revenues	Expenses
Accounts payable			X				
Accounts receivable, less allowances		X					
Accrued expenses			X				

Solutions to Review Problems

Review 3-1—Solution

	Cash Asset	Noncash Asset	Liabilities	Contributed Capital	Earned Capital	Revenues	Expenses
Accounts payable			X				
Accounts receivable, less allowances		X					
Accrued expenses			X				
Acquired intangible assets, net		X					
Cash and cash equivalents	X						
Common stock and additional paid-in capital				X			
Cost of sales							X
Current portion of long-term debt			X				
Deferred revenue			X				
Deferred tax assets		X					
Goodwill		X					
Inventories		X					
Long-term debt			X				
Long-term marketable securities		X					
Net sales						X	
Other current assets		X					
Other non-current liabilities			X				
Property, plant, and equipment, net		X					
Provision for income taxes							X
Research and development							X
Retained earnings					X		
Selling, general and administrative							X

Review 3-2—Solution

	Balance Sheet					Income Statement		
	Cash Assets +	Noncash Assets =	Liabil-ities +	Contrib. Capital +	Earned Capital	Rev-enues −	Expen-ses =	Net Income
Balance January 1, 2017	10,000	41,000	26,000	10,000	15,000	0	0	0
Transactions								
1. Issue common stock for $3,000 cash	3,000			3,000				
2. Purchase inventory for $8,000 on credit		8,000 Inventory	8,000 Accounts payable					

Review 3-2—Solution

	Balance Sheet					Income Statement		
	Cash Assets +	Noncash Assets =	Liabil-ities +	Contrib. Capital +	Earned Capital	Rev-enues −	Expen-ses =	Net Income
Balance January 1, 2017	10,000	41,000	26,000	10,000	15,000	0	0	0
Transactions								
1. Issue common stock for $3,000 cash	3,000			3,000				
2. Purchase inventory for $8,000 on credit		8,000 Inventory	8,000 Accounts payable					
3. Sell inventory costing $8,000 for $15,000 on credit		(8,000) Inventory 15,000 Accounts receivable			7,000	15,000 Revenue	8,000 Cost of goods sold	7,000
4. Issue long-term debt for $10,000 cash	10,000		10,000 Long-term debt					
5. Pay $15,000 cash for PPE	(15,000)	15,000 PPE						
6. Pay $500 cash for salaries	(500)				(500)		500 Salaries expense	(500)
7. Receive $300 cash in advance for future consulting services	300		300 Unearned revenue					
8. Pay $50 cash for interest on long-term debt	(50)				(50)		50 Interest expense	(50)
9. Receive $3,000 cash from accounts receivable	3,000	(3,000) Accounts receivable						
10. Pay $2,500 cash toward accounts payable	(2,500)		(2,500) Accounts payable					
11. Perform consulting services for client who previously paid in 7			(300) Unearned revenue		300	300 Revenue		300
12. Pay $100 cash for dividends	(100)				(100)			

Review 3-3—Solution

	Balance Sheet					Income Statement		
	Cash Assets +	Noncash Assets =	Liabil-ities +	Contrib. Capital +	Earned Capital	Rev-enues −	Expen-ses =	Net Income
Accounting Adjustments								
13. Record depreciation of $600		(600) PPE			(600)		600 Depreciation expense	(600)
14. Accrue salaries of $1,000			1,000 Salaries payable		(1,000)		1,000 Salaries expense	(1,000)
15. Advertising costing $1,300 is aired		(1,300) Prepaid expense			(1,300)		1,300 Advertising expense	(1,300)
16. Accrue income taxes of $1,200			1,200 Taxes payable		(1,200)		1,200 Tax expense	(1,200)
Balance January 31, 2017	8,150	66,100	8,150	13,000	17,550	15,300	12,650	2,650

Review 3-4—Solution

1.

Cash	$ 8,150	Taxes payable	$ 1, 200
Accounts receivable	24,000	Unearned revenue	200
Inventory	7,200	Long-term debt	32,000
Prepaid advertising	500	Common stock	13,000
PPE	34,400	Retained earnings	17,550

Review 3-4—Solution

1.

Cash	$ 8,150	Taxes payable	$ 1, 200
Accounts receivable	24,000	Unearned revenue	200
Inventory	7,200	Long-term debt	32,000
Prepaid advertising	500	Common stock	13,000
PPE	34,400	Retained earnings	17,550
Accounts payable	9,300	Revenues	15,300
Salaries payable	1,000	Expenses	12,650

2.

PRESTIGE INC.
Income Statement
For Month Ended January 31, 2017

Revenues	$15,300
Cost of goods sold	8,000
Gross profit	7,300
Salaries expense	1,500
Depreciation expense	600
Advertising expense	1,300
Operating profit	3,900
Interest expense	50
Profit before tax	3,850
Tax expense	1,200
Net income	$ 2,650

PRESTIGE INC.
Statement of Retained Earnings
For Month Ended January 31, 2017

Beginning retained earnings	$15,000
Net income	2,650
Dividends	(100)
Ending retained earnings	$17,550

PRESTIGE INC.
Balance Sheet
January 31, 2017

Cash	$ 8,150
Accounts receivable	24,000
Inventories	7,200
Prepaid advertising	500
Current assets	39,850
Property, plant and equipment	34,400

PRESTIGE INC.
Balance Sheet
January 31, 2017

Cash	$ 8,150
Accounts receivable	24,000
Inventories	7,200
Prepaid advertising	500
Current assets	39,850
Property, plant, and equipment	34,400
Total assets	$74,250
Accounts payable	$ 9,300
Wages payable	1,000
Taxes payable	1,200
Unearned revenue	200
Current liabilities	11,700
Long-term debt	32,000
Total liabilities	43,700
Common stock	13,000
Retained earnings	17,550
Total stockholders' equity	30,550
Total liabilities and stockholders' equity	$74,250

Review 3-5—Solution

1. Close revenue account.

Revenues (REV)	15,300	
Retained earnings (RE)		15,300

REV	
15,300	

RE	
	15,300

2. Close expense accounts.

Retained earnings (RE)	8,000	
Cost of goods sold (COGS)		8,000

RE	
8,000	

COGS	
	8,000

Retained earnings (RE)	1,500	
Salaries expense (SE)		1,500

RE	
1,500	

SE	
	1,500

Retained earnings (RE)	600	
Depreciation expense (DE)		600

RE	
600	

DE	
	600

Retained earnings (RE)	1,300	
Advertising expense (AE)		1,300

RE	
1,300	

AE	
	1,300

Retained earnings (RE)	50	
Interest expense (IE)		50

Retained earnings (RE)	1,300	
Advertising expense (AE)		1,300

RE	
1,300	

AE	
	1,300

Retained earnings (RE)	50	
Interest expense (IE)		50

RE	
50	

IE	
	50

Retained earnings (RE)	1,200	
Tax expense (TE)		1,200

RE	
1,200	

TE	
	1,200

3. Close dividend account.

Retained earnings (RE)	100	
Dividends (DIV)		100

RE	
100	

DIV	
	100

Auto Zoom ▾ 3-40

Module 4

Analyzing and Interpreting Financial Statements