# CHAPTER 4

## DISCUSSION QUESTIONS

**1.** Accountants prepare financial reports on a periodic basis in order to furnish decision makers with timely information. Investors, creditors, management, and others cannot wait until the results of operations are known at the termination of business. They must have periodic and timely information, even if the information must be based on estimates and the results are somewhat tentative.

**2.** A 12-month accounting period is known as a company’s fiscal year. Only when a company closes its books on December 31 is it said to be reporting on a calendar-year basis.

**3.** According to IAS18, for a sale of goods to be recognized as revenue, the amount of revenue and the costs incurred or to be incurred should be reliably measurable, and it is probable that the economic benefits (in most cases, cash) from the sale will flow to the seller. In addition, the seller should not continue managerial involvement in or maintain control over the goods. Finally, the rewards and significant risks associated with owning the goods should be transferred to the buyer.

**4.** The matching principle states that all costs and expenses incurred during a period to generate recognized revenues should be associated with those revenues in determining income (or loss) for the period.

**5.** Accrual-basis accounting recognizes revenues and expenses as they are earned and incurred, which is not necessarily in the same period as when cash is received or paid. For most businesses, this provides a more realistic measurement of income or loss. Accrual-basis accounting also provides a more correct financial picture of an entity’s resources and obligations.

**6.** Accrual-based financial statements are considered somewhat tentative because the accounting measurements include amounts based on estimates and judgments. The exact results of business activity can be known only when activity has ceased and all resource flows can be accurately quantified.

**7.** Adjusting entries are needed for two reasons: (a) to recognize the proper amounts of revenues earned and expenses incurred during a period of time and (b) to report the appropriate balances in the asset, liability, and equity accounts at a particular date.

**8.** An accountant generally is not able to depend on source documents as the basis for adjusting entries. Instead, accountants must analyze the accounts at the end of the accounting period, prior to preparing the financial statements, to see which accounts need to be recorded (for unrecorded receivables and liabilities) and which accounts need to be adjusted and brought current (for prepaid expenses and unearned revenues). The amount of the adjusting entry depends on the original entry, if any, that has been made and what the updated balance in the account should be. The adjusting entries bring the accounts to their updated balances at the end of the period so proper results are reported in the financial statements.

**9.** The two basic steps involved in preparing adjusting entries are: (1) fix the balance sheet by making sure all assets, liability, and equity amounts are recorded correctly and (2) fix the statement of comprehensive income by making sure all revenues and expenses for the period are properly recorded.

Both steps are necessary for the correct amounts to be reported on the balance sheet (the financial position of the entity at the end of the period) and the statement of comprehensive income (the results of operations for the period).

**10.** The cash account is not increased or decreased as a result of adjusting entries because, as cash is received or paid, the original entries correctly reflect increases or decreases in that account. Cash is adjusted at the end of a period only when there has been an error in recording past cash transactions.

The primary purpose of adjusting entries, however, is not to correct errors. The main objective is to record previously unrecorded items and to adjust the balances in accounts, so the appropriate amounts of revenues and expenses are recognized on the statement of comprehensive income and the updated balances are reported on the balance sheet.

**11.** Financial statements are usually prepared after the accounts are brought current through the adjusting process. Any omission or error discovered during financial statement preparation can then be corrected, often with another adjusting entry.

**12.** Nominal, or temporary, accounts are reduced to a zero balance through the closing process at the end of each accounting period. Since these accounts begin each period with a zero balance, they show the results of operations for the current accounting period only. With the exception of Dividends, nominal accounts appear on the statement of comprehensive income.

Real, or permanent, accounts appear on the balance sheet and are not closed to a zero balance at the end of an accounting period. The balances in real accounts are carried forward to the next accounting period.

**13.** Closing entries provide an orderly process of transferring the balances of all temporary accounts (revenues, expenses, and dividends) to equity. With zero balances, these nominal accounts are then ready for the next accounting cycle of the business.

**14.** The post-closing trial balance lists the balances of all real accounts after the closing process has been completed. It provides a means of testing whether total debits equal total credits for all real accounts prior to beginning a new accounting cycle.

The information for the post-closing trial balance comes from the account balances of the general ledger, but only after the closing entries have been recorded and posted to the general ledger.

## PRACTICE EXERCISES

### PE4–1 (LO1) Periodic Reporting

The correct answer is D.

a. False. There is no requirement to do so.

b. False. More frequent reporting *increases* the need for accountants to make estimates and judgments.

c. False. Most businesses, large and small, prepare periodic financial reports.

d. True. Management is free to arrange for the preparation of any useful periodic financial reports. For example, sales reports might be prepared on a daily, or even an hourly, basis.

e. False. The SEC requires all publicly traded companies in the United States to file *quarterly* financial statements.

### PE 4–2 (LO1) Periodic Reporting

d

### PE 4–3 (LO1) Matching Principle

c

### PE 4–4 (LO1) Cash-Basis Accounting

For 2017

Cash receipts $92,000

Cash disbursements 73,000

Cash-basis income $19,000

### PE 4–5 (LO1) Accrual-Basis Accounting

For 2017

Revenues earned $ 135,000

Expenses incurred ($73,000 + $41,000) 114,000

Accrual-basis income (loss) $ 21,000

### PE 4–6 (LO2) Unrecorded Receivable: Original Entry

Dec. 10 Cash 12,300

Delivery Revenue 12,300

### PE 4–7 (LO2) Unrecorded Receivable: Adjusting Entry

1. Dec. 31 Accounts Receivable 13,700

Delivery Revenue 13,700

2. Jan. 10 Cash 13,700

Accounts Receivable 13,700

Note that no revenue is recognized on January 10. Because the revenue was earned in December, it was recognized through the adjusting entry made on December 31.

### PE 4–8 (LO2) Unrecorded Liability: Original Entry

May 1 Cash 50,000

Loan Payable 50,000

### PE 4–9 (LO2) Unrecorded Liability: Adjusting Entry

1. Dec. 31 Interest Expense 4,000

Interest Payable 4,000

$50,000 × 0.12 × 8/12 = $4,000; 8 months elapse from May 1

through December 31.

2. Apr. 30 Interest Expense 2,000

Interest Payable 4,000

Cash 6,000

$50,000 × 0.12 × 12/12 = $6,000; 12 months of interest from

May 1 through the following April 30.

$50,000 × 0.12× 4/12 = $2,000; 4 months elapse from January 1

through April 30.

### PE 4–10 (LO2) Prepaid Expense: Original Entry

Aug. 1 Prepaid Insurance 86,400

Cash 86,400

### PE 4–11 (LO2) Prepaid Expense: Adjusting Entry

1. Dec. 31 Insurance Expense 9,000

Prepaid Insurance 9,000

$86,400÷ 48 months = $1,800 per month.

$1,800 × 5 months = $9,000 insurance used up;

5 months from August 1 through December 31.

2.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| PREPAID INSURANCE | | | | |
| Debit (+) | | Credit (–) | | |
| Beg. bal. | 0 |  |  |
| Aug. 1 | 86,400 |  |  |
|  |  | Dec. 31 Adj. | 9,000 |
| End. bal. | 77,400 |  |  |
|  |  |  |  |

The $77,400 ending balance represents another 43 months of insurance coverage (43 × $1,800 = $77,400).

### PE 4–12 (LO2) Unearned Revenue: Original Entry

Apr. 1 Cash 270,000

Unearned Security Revenue 270,000

### PE 4–13 (LO2) Unearned Revenue: Adjusting Entry

1. Dec. 31 Unearned Security Revenue 67,500

Security Revenue 67,500

$270,000 ÷ 36 months = $7,500 per month.

$7,500 × 9 months = $67,500 security revenue earned;

9 months from April 1 through December 31.

2.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| UNEARNED SECURITY REVENUE | | | | |
| Debit (–) | | Credit (+) | | |
|  |  | Beg. bal. | 0 |
|  |  | Mar. 1 | 270,000 |
| Dec. 31 Adj. | 67,500 |  |  |
|  |  | End. bal. | 202,500 |
|  |  |  |  |

The $202,500 ending balance represents another 27 months of revenue not yet earned (27 × $7,500 = $202,500).

### PE 4–14 (LO2) Wages Payable: Adjusting Entry and Subsequent Payment

1. Dec. 31 Wages Expense 5,400

Wages Payable 5,400

$13,500 ÷ 5 days = $2,700 per day.

$2,700 × 2 days = $5,400 wages owed to employees;

2 days from Monday through Tuesday.

2. Jan. 3 Wages Expense 8,100

Wages Payable 5,400

Cash 13,500

$2,700 × 3 days = $8,100 wages earned by employees;

3 days from Wednesday through Friday.

### PE 4–15 (LO2) Supplies: Original Purchase and Adjusting Entry

1. Mar. 23 Office Supplies 9,000

Cash 9,000

2. Dec. 31 Office Supplies Expense 12,500

Office Supplies 12,500

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| OFFICE SUPPLIES | | | | |
| Debit (+) | | Credit (–) | | |
| Beg. bal. | 6,400 |  |  |
| Mar. 23 | 9,000 |  |  |
|  |  | Dec. 31 Adj. | 12,500 |
| End. bal. | 2,900 |  |  |
|  |  |  |  |

$6,400 beginning + $9,000 purchased = $15,400 supplies available.

$15,400 supplies available – $2,900 remaining = $12,500 supplies used.

### PE 4–16 (LO3) Preparing an Adjusted Trial Balance

1. a. Dec. 31 Interest Receivable 9,240

Interest Revenue 9,240

$144,000 × 0.11 × 7/12 = $9,240; 7 months elapse from

June 1 through December 31.

b. Dec. 31 Unearned Fee Revenue 68,750

Fee Revenue 68,750

$225,000 ÷ 36 months = $6,250 per month.

$6,250 × 11 months = $68,750 fee revenue earned;

11 months from February 1 through December 31.

c. Dec. 31 Rent Expense 9,600

Prepaid Rent 9,600

$192,000 ÷ 60 months = $3,200 per month.

$3,200 × 3 months = $9,600 prepaid rent used up;

3 months from October 1 through December 31.

d. Dec. 31 Wages Expense 17,000

Wages Payable 17,000

2. Debits Credits

Cash $ 87,000

Notes Receivable 144,000

Interest Receivable 9,240

Prepaid Rent ($192,000 – $9,600) 182,400

Building 210,000

Accounts Payable $165,000

Wages Payable 17,000

Unearned Fee Revenue ($225,000 – $68,750) 156,250

Capital Stock 200,000

Retained Earnings 90,000

Dividends 22,000

Fee Revenue ($257,000 + $68,750) 325,750

Interest Revenue 9,240

Wages Expense ($229,000 + $17,000) 246,000

Utilities Expense 53,000

Rent Expense 9,600

Totals $963,240 $963,240

### PE 4–17 (LO3) Using an Adjusted Trial Balance to Prepare a Statement of comprehensive income

Fee revenue $325,750

Interest revenue 9,240

Total revenue $334,990

Expenses:

Wages expense $246,000

Utilities expense 53,000

Rent expense 9,600 308,600

Net income $ 26,390

Other comprehensive income 0

Comprehensive income $ 26,390

### PE 4–18 (LO3) Using an Adjusted Trial Balance to Prepare a Balance Sheet

Assets

Cash $ 87,000

Notes receivable 144,000

Interest receivable 9,240

Prepaid rent 182,400

Building 210,000

Total assets $632,640

Liabilities and Equity

Accounts payable $165,000

Wages payable 17,000

Unearned fee revenue 156,250

Capital stock 200,000

Retained earnings 94,390\*

Total liabilities and equity $632,640

\*Beginning retained earnings $90,000 + Net income $26,390 (see PE 4–17) – Dividends $22,000.

### PE 4–19 (LO4) Closing Entries: Revenues

Services Revenue 6,000

Interest Revenue 100

Retained Earnings 6,100

### PE 4–20 (LO4) Closing Entries: Expenses

Retained Earnings 3,800

Insurance Expense 1,300

Advertising Expense 2,500

### PE 4–21 (LO4) Closing Entries: Everything

1. Sales Revenue 9,990

Rent Revenue 925

Retained Earnings 10,915

Retained Earnings 8,300

Wages Expense 5,100

Utility Expense 3,200

Retained Earnings 1,200

Dividends 1,200

2.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| RETAINED EARNINGS | | | | |
| Debit (–) | | Credit (+) | | |
|  |  | Beg. bal. | 1,500 |
|  |  | Revenues | 10,915 |
| Expenses | 8,300 |  |  |
| Dividends | 1,200 |  |  |
|  |  | End. bal. | 2,915 |
|  |  |  |  |

### PE 4–22 (LO4) Post-Closing Trial Balance

Debits Credits

Cash $ 87,000

Notes Receivable 144,000

Prepaid Rent 192,000

Building 210,000

Accounts Payable $165,000

Unearned Fee Revenue 225,000

Capital Stock 200,000

Retained Earnings 43,000\*

Totals $633,000 $633,000

\*Ending retained earnings = $90,000 (beginning) + $257,000 (revenues) – $282,000 (expenses) – $22,000 (dividends) = $43,000.

## EXERCISES

### E 4–1 (LO1) Reporting Income: Cash versus Accrual Accounting

1. a. Cash-basis:

Collections from customers 　$150,560

Interest received 3,500

Wages paid to employees (78,000)

Rent paid for 1.5 years (36,000)

Net income $ 40,060

b. Accrual-basis:

Sales to customers $ 329,000

Interest earned 3,500

Wages earned and paid to employees (78,000)

Wages earned and owed to employees at year-end (3,500)

Utility bill owed (1,750)

Interest due at 12/31 (2,400)

Amount paid for rent for 1 year ………………………………… (24,000)

Income taxes owed at year-end (7,000)

Net income $ 215,850

2. Accrual-basis accounting provides Ryan with the better measure of his company’s operating results. It matches earned revenues with the expenses incurred to generate those revenues during the reporting period. Because it is a better measure of net income, accrual-basis accounting is required by generally accepted accounting principles (GAAP).

### E 4–2 (LO1) Reporting Income: Cash versus Accrual Accounting

1. a. Cash-basis:

Cash receipts:

From customers $185,000

From interest 1,100 $186,100

Cash disbursements:

For rent $ 18,000

For wages 71,000 89,000

Net income for the year $ 97,100

E 4–2 (LO1) (Continued)

b. Accrual-basis:

Revenues:

Services $265,000

Interest 1,100 $266,100

Expenses:

Rent 12,000

Utilities 1,350

Wages ($71,000 + $3,500) 74,500

Interest 950 88,800

Net income for the year $ 177,300

2. Accrual-basis accounting provides a better measure of operating results. It reflects the sales that have been earned, not just the cash collected, and it reports the expenses incurred, not just the cash paid. Note that cash flows are important for assessing liquidity. Daniel would have to be careful not to spend more money than he is bringing in, especially as a new business. However, as a measure of ongoing profitability, the accrual-basis net income amount ($177,300 in this case) is the better measure of operating results.

### E 4-3 (LO1, 2) Identifying Accounting Concepts

1. (b) 2.(c) 3. (f) 4. (a),(d),(e)

### E 4–4 (LO2) Adjusting Entries: Prepaid Expenses and Unearned Revenues

1. *Original entry*

Prepaid Insurance 5,400

Cash 5,400

*Adjusting entry*

Insurance Expense 900

Prepaid Insurance 900

*($5,400/3 years = $1,800 per year; $1,800 year ×*

*1/2 year = $900)*

E 4–4 (LO2) (Continued)

2. *Original entry*

Prepaid Property Taxes 2,400

Cash 2,400

*Adjusting entry*

Property Tax Expense 2,200

Prepaid Property Taxes 2,200

*($2,400/12 months = $200 per month; $200 × 11*

*months = $2,200)*

3. *Original entry*

Prepaid Subscriptions 360

Cash 360

*Adjusting entry*

Subscription Expense 80

Prepaid Subscriptions 80

*($360/36 months = $10 per month; $10 × 8 months*

*= $80)*

4. *Original entry*

Cash 3,600

Unearned Consulting Fees Revenue 3,600

*Adjusting entry*

Unearned Consulting Fees Revenue 700

Consulting Fees Revenue 700

*($3,600/18 months = $200 per month; $200 per*

*month × 3.5 months = $700)*

5. *Original entry*

Cash 900

Unearned Rent Revenue 900

*Adjusting entry*

Unearned Rent Revenue 300

Rent Revenue 300

*($900/6 months = $150 per month; $150 × 2*

*months = $300)*

E 4–4 (LO2) (Continued)

6. *Original entry*

Cash 14,400

Unearned Interest Revenue 14,400

*Adjusting entry*

Unearned Interest Revenue 1,200

Interest Revenue 1,200

*($14,400/24 months = $600 per month; $600 ×*

*2 months = $1,200)*

### E 4–5 (LO2) Adjusting Entries: Prepaid Expenses and Unearned Revenues

1. *Original entry*

Mar. 15 Cash 54,000

Unearned Consulting Fees 54,000

*Adjusting entry*

Dec. 31 Unearned Consulting Fees 28,500

Consulting Fees Revenue 28,500

*($54,000/18 months = $3,000 per month;*

*$3,000 × 9.5 months = $28,500)*

2. *Original entry*

Apr. 1 Prepaid Subscriptions 285

Cash 285

*Adjusting entry*

Dec. 31 Subscription Expense 107

Prepaid Subscriptions 107

*($285/24 months = $11.88 pr month;*

*$11.88 × 9 months = $107)*

3. *Original entry*

May 1 Prepaid Property Taxes 7,500

Cash 7,500

*Adjusting entry*

Dec. 31 Property Tax Expense 5,000

Prepaid Property Taxes 5,000

*($7,500/12 months = $625.00 per month;*

*$625 × 8 months = $5,000)*

E 4–5 (LO2) (Continued)

4. *Original entry*

Aug. 1 Cash 3,350

Unearned Rent 3,350

*Adjusting entry*

Dec. 31 Unearned Rent 2,792

Rent Revenue 2,792

*($3,350/6 months = $558.33 per month;*

*$558.33 × 5 months = $2,792)*

5. *Original entry*

Sept. 1 Prepaid Insurance 30,000

Cash 30,000

*Adjusting entry*

Dec. 31 Insurance Expense 5,000

Prepaid Insurance 5,000

*($30,000/24 months = $1,250 per month;*

*$1,250 × 4 months = $5,000)*

6. *Original entry*

Oct. 1 Cash 13,300

Unearned Interest Revenue 13,300

*Adjusting entry*

Dec. 31 Unearned Interest Revenue 3,325

Interest Revenue 3,325

*($13,300/12 months = $1,108.33 per month;*

*$1,108.33 × 3 months = $3,325)*

### E 4–6 (LO2) Adjusting Entries

1. June 1 Cash 4,800

Unearned Subscription Revenue 4,800

*To record receipt of two-year subscription.*

Dec. 31 Unearned Subscription Revenue 1,400

Subscription Revenue 1,400

*To record seven months of revenue earned.*

*($4,800/24 months = $200 per month × 7 months*

*= $1,400)*

2. a. Dec. 31 Salaries Expense 72,000

Salaries Payable 72,000

*To record salaries payable for two days.*

*($180,000 × 2/5 = $72,000)*

b. Jan. 3 Salaries Payable 72,000

Salaries Expense 108,000

Cash 180,000

*To record payment of salaries for the week.*

*($180,000× 3/5 = $108,000)*

### E 4–7 (LO2) Adjusting Entries

1. Interest Expense 9,000

Interest Payable 9,000

*To record interest expense for six months.*

*($225,000 × 0.08 × 6/12 = $9,000)*

2. Unearned Rent Revenue 14,000

Rent Revenue 14,000

*To record rental revenue for four months.*

*($21,000 × 4/6 = $14,000)*

3. Office Supplies Expense 3,985

Office Supplies 3,985

*To record office supplies expense.*

*($1,005 + $4,300 – $1,320 = $3,985)*

4. Interest Receivable 5,775

Interest Revenue 5,775

*To record interest revenue for 11 months.*

*($90,000 × 0.07 × 11/12 = $5,775)*

### E 4–8 (LO2) Adjusting Entries

1. Feb. 1 Prepaid Rent 24,000

Cash 24,000

*To record prepayment of rent for one year.*

Dec. 31 Rent Expense 22,000

Prepaid Rent 22,000

*To record rent expense for 11 months.*

*($24,000 × 11/12 = $22,000)*

2. Mar. 31 Cash 50,000

Bank Loan Payable 50,000

*To record $50,000, 15%, one-year loan.*

Dec. 31 Interest Expense 5,625

Interest Payable 5,625

*To record interest expense for nine months.*

*($50,000 × 0.15 × 9/12 = $5,625)*

3. Recorded upon receipt

Cash 60,000

Unearned Design Revenue 60,000

*To record receipt of design fees in advance.*

Dec. 31 Unearned Design Revenue 36,000

Design Revenue 36,000

*To record design revenue earned.*

*[$60,000 × (1 – 0.40) = $36,000]*

4. June 15 Supplies 1,400

Cash 1,400

*To record purchase of supplies.*

Sept. 14 Supplies 1,100

Cash 1,100

*To record purchase of supplies.*

Dec. 31 Supplies Expense 1,700

Supplies 1,700

*To record supplies used during the period.*

5. Dec. 31 Programming Expense 800

Accounts Payable 800

*To record programming expense.*

### E 4–9 (LO2) Adjusting Entries

1. Insurance Expense 18,000

Prepaid Insurance 18,000

*To recognize six months of insurance expense.*

*($54,000 × 6/18 = $18,000)*

2. Unearned Rent Revenue 4,000

Rent Revenue 4,000

*To recognize two months of rent revenue.*

*($12,000 × 2/6 = $4,000)*

3. Interest Expense 4,583

Interest Payable 4,583

*To record 11 months of interest expense to be paid*

*next year. ($50,000 × 0.10 × 11/12 = $4,583)*

4. Interest Receivable 450

Interest Revenue 450

*To record three months of interest revenue.*

*($15,000 × 0.12 × 3/12 = $450)*

### E 4–10 (LO2) Adjusting Entries

1. Supplies Expense 1,435

Supplies 1,435

*Beginning supplies on hand ($245) + Supplies*

*purchased ($1,950) – Ending supplies on hand*

*($760) = Supplies used during the year ($1,435).*

2. Salaries Expense 19,000

Salaries Payable 19,000

Cash 38,000

*To recognize one-half month of salaries expense.*

*($38,000/2 = $19,000)*

3. Unearned Revenue 10,500

Service Revenue 10,500

*One-fourth of the $42,000 has been earned.*

*($42,000/4 = $10,500)*

4. No adjusting entry

*(This payment relates only to January’s rent. As such, the company does not recognize any expense until January of the next year.)*

### E 4–11 (LO2) Analysis of Accounts

1. Amount of office supplies on hand = $3,725, as follows:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | SUPPLIES  ON HAND | |  | CASH | |  | SUPPLIES  EXPENSE | |
| Beginning balance |  | 2,750 |  |  |  |  |  |  |  |
| Purchases |  | 14,200 |  |  |  | 14,200 |  |  |  |
| Adjusting entry  (12/31) |  |  | 13,225 |  |  |  |  | 13,225 |  |
| Updated balance  (12/31) |  | 3,725 |  |  |  |  |  | 13,225 |  |
|  |  |  |  |  |  |  |  |  |  |

2. Cash collected from customers = $168,000, as follows:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | ACCOUNTS RECEIVABLE | |  | CASH | |  | SALES | |
| Beginning balance |  | 76,000 |  |  |  |  |  |  |  |
| Sales for period |  | 174,000 |  |  |  |  |  |  | 174,000 |
| Cash collections |  |  | 168,000 |  | 168,000 |  |  |  |  |
| Updated balance  (12/31) |  | 82,000 |  |  |  |  |  |  | 174,000 |
|  |  |  |  |  |  |  |  |  |  |

3. Rent collected in advance = $24,500, as follows:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | UNEARNED  RENT | |  | CASH | |  | RENT REVENUE | |
| Beginning balance |  |  | 8,000 |  |  |  |  |  |  |
| Collections in  advance |  |  | 24,500 |  | 24,500 |  |  |  |  |
| Revenue for period |  | 23,000 |  |  |  |  |  |  | 23,000 |
| Updated balance  (12/31) |  |  | 9,500 |  |  |  |  |  | 23,000 |
|  |  |  |  |  |  |  |  |  |  |

### E4- 12 (LO2) Identifying Types of Adjustments and Account Relationships

|  |  |  |
| --- | --- | --- |
| **Item** | 1. **Type of Adjustment** | **(b) Accounts before Adjustment** |
| **1.** | **Accrued Revenues** | Assets Understated  Revenues Understated |
| **2.** | **Prepaid Expenses** | Assets Overstated  Expenses Understated |
| **3.** | **Accrued Expenses** | Expenses Understated  Liabilities Understated |
| **4.** | **Unearned Revenues** | Liabilities Overstated  Revenues Understated |
| **5.** | **Accrued Expenses** | Expenses Understated  Liabilities Understated |
| **6.** | **Prepaid Expenses** | Assets Overstated  Expenses Understated |
|  |  |  |

### E 4–13 (LO3) Classifying Account Balances

1. BS

2. S/CI

3. BS

4. BS

5. S/CI

6. BS

7. S/CI

8. BS

9. BS

10. BS

11. BS

12. BS

13. S/CI

14. BS

15. BS

16. BS

17. S/CI

18. S/CI

19. BS

20. BS

21. BS

22. BS

23. BS

24. N\*

\*Note that Dividends would be closed to Retained Earnings and is not shown on the balance sheet or the statement of comprehensive income..

### E4-14 (LO3) Preparing Financial Statements from Adjusted Trial Balance

BUNNY COMPANY

Statement of Comprehensive Income

For the Year Ended June 30, 2017

Revenues

Service revenue $35,200

Rent revenue 11,700

Total revenues  46,900

Expenses

Salaries and wages expense $18,100

Rent expense  15,000

Supplies expense   1,600

Insurance expense   1,500

Depreciation expense 1,300

Total expenses 37,500

Net income $ 9,400

BUNNY COMPANY

Statement of Retained Earnings

For the Year Ended June 30, 2017

Retained earnings, July 1, 2015 $ 3,600

Add: Net income 9,400

Retained earnings, June 30, 2017 $13,000

BUNNY COMPANY

Balance Sheet

June 30, 2017

Assets

Current assets:

Cash    $ 10,400

Accounts receivable  10,000

Supplies     700

Prepaid insurance   2,500

Long-term assets:

Equipment $14,000

Less: Accum. depreciation—equipment (4,900) 9,100

Total assets $32,700

Equity and Liabilities

Current liabilities:

Unearned rent revenues $ 800

Salaries and wages payable   1,100

Accounts payable 5,800

Total Liabilities $ 7,700

Equity

Capital stock $12,000

Retained earnings 13,000

Total Equity 25,000

Total equity and liabilities $32,700 $32,700

### E 4–15 (LO4) Real and Nominal Accounts

1. R

2. N

3. R

4. R

5. R

6. R

7. N

8. R

9. N

10. R

11. N

12. R

13. R

14. N

15. R

16. N

17. N

18. R

19. R

20. N

21. R

22. R

23. N

### E 4–16 (LO4) Closing Entry

1. Sales Revenue 867,650

Operating Expenses 650,000

Income Tax Expense 76,178

Retained Earnings 141,472

2. The statement of comprehensive income may combine or condense several accounts and report them in summary form. If closing entries are prepared from these summarized data, the individual revenue and expense accounts might not be reduced to a zero balance. For example, if Basket Weavers Inc. has several operating expense accounts, it would not be sufficient to close the combined total of $650,000. Each individual expense account in the ledger, the total of which is $650,000, must be closed.

### E 4–17 (LO4) Closing Entries

Services Revenue 215,890

Retained Earnings 215,890

Retained Earnings 3,000

Insurance Expense 3,000

Retained Earnings 100,000

Administrative Expenses 100,000

Retained Earnings 30,100

Income Tax Expense 30,100

*Note:* Alternatively, the above journal entries may be combined into the following compound journal entry:

Services Revenue 215,890

Insurance Expense 3,000

Administrative Expenses 100,000

Income Tax Expense 30,100

Retained Earnings 82,790

The net result on Retained Earnings is the same under both journal entries.

### E 4–18 (LO4) Closing Entries

Services Revenue 906,000

Retained Earnings 906,000

Interest Revenue 23,000

Retained Earnings 23,000

Retained Earnings 450,000

Salaries Expense 450,000

Retained Earnings 140,000

Utilities Expenses 140,000

Retained Earnings 135,600

Income Tax Expense 135,600

*Note:* Alternatively, the above journal entries may be combined into the following compound journal entry:

Services Revenue 906,000

Interest Revenue 23,000

Salaries Expense 450,000

Utilities Expenses 140,000

Income Tax Expense 135,600

Retained Earnings 203,400

The net result on Retained Earnings is the same under both journal entries.

### E 4–19 (LO4) Closing Dividends and Preparing a Post-Closing Trial Balance

1. Retained Earnings 55,000

Dividends 55,000

2. Contemporary Literature Enterprises

Post-Closing Trial Balance

December 31, 2017

Debits Credits

Cash $ 63,710

Accounts Receivable 154,230

Prepaid Insurance 10,070

Land 430,800

Accounts Payable $ 68,540

Notes Payable 92,000

Salaries Payable 27,100

Taxes Payable 36,990

Unearned Rent 18,400

Mortgage Payable 190,500

Capital Stock 130,000

Retained Earnings 95,280\*

Totals $658,810 $658,810

\*$150,280 – $55,000 = $95,280

### E 4–20 (LO4) Closing Dividends and Preparing a Post-Closing Trial Balance

1. Retained Earnings 14,800

Dividends 14,800

2. Jolley Manufacturing Corporation

Post-Closing Trial Balance

December 31, 2017

Debits Credits

Cash $ 16,400

Accounts Receivable 23,500

Prepaid Advertising 4,000

Building 181,000

Land 45,000

Accounts Payable $ 24,000

Wages Payable 8,000

Income Taxes Payable 7,000

Mortgage Payable 82,500

Notes Payable 23,000

Unearned Rent 4,200

Capital Stock 80,000

Retained Earnings 41,200\*

Totals $269,900 $269,900

\*$56,000 – $14,800 = $41,200

## PROBLEMS

### P 4–1 (LO1) Cash- and Accrual-Basis Accounting

1. Cash-basis:

Cash collected from providing services $352,000

Expenses:

Salaries paid in 2017 $53,000

Utility bills paid in 2017 6,300

Taxes paid in 2017 5,930

Rent paid in 2017 41,000 106,230

Net income $245,770

2. Accrual-basis:

Services revenue $327,000

Expenses:

Salaries expense for 2017 $61,000

Utilities expense for 2017 7,500

Tax assessment for 2017 6,210

Rent expense for 2017 36,000 110,710

Net income $216,290

3. Accrual-basis accounting recognizes revenues when they are earned by a firm and recognizes expenses as they are incurred, not necessarily when cash is received or paid. In determining income on an accrual basis, only revenues that have actually been earned during a period are reported. Similarly, the expenses incurred to generate those revenues are associated with the same period.

Under cash-basis accounting, ample opportunity exists to manipulate income. A firm could delay or prepay expenses in order to affect the amount of income reported for the period.

### P 4–2 (LO2) Adjusting Entries

a. Salaries Expense 17,840

Salaries Payable 17,840

b. Interest Expense 5,225

Interest Payable 5,225

*($190,000 × 0.11 × 3/12 year = $5,225)*

P 4–2 (LO2) (Continued)

c. Rent Expense 6,000

Prepaid Rent 6,000

*($36,000/6 months = $6,000; $6,000 × 1 month = $6,000)*

d. Unearned Rent Revenue 33,900

Rent Revenue 33,900

*($76,000 – $42,100 = $33,900)*

e. Insurance Expense 2,400

Prepaid Insurance 2,400

f. Interest Receivable 400

Interest Revenue 400

### P 4–3 (LO2) Adjusting Entries

a. Interest Expense 9,600

Interest Payable 9,600

*($320,000 × 0.09 × 4/12 = $9,600)*

b. Unearned Rent Revenue 51,250

Rent Revenue 51,250

*($93,500 – $42,250 = $51,250)*

c. Interest Receivable 9,450

Interest Revenue 9,450

d. Insurance Expense 4,960

Prepaid Insurance 4,960

e. Rent Expense 7,500

Prepaid Rent 7,500

*($30,000/6 months = $5,000 per month;*

*$5,000 × 1 1/2 months = $7,500)*

f. Salaries Expense 15,300

Salaries Payable 15,300

### P 4–4 (LO2) Year-End Analysis of Accounts

1. Wages Payable balance at December 31, 2017 $ 3,400

Add cash wages paid in 2017 30,000

Total $33,400

Less balance of Wages Payable at January 1, 2017 2,600

Wages Expense for 2017 $30,800

2. Unearned Rent at January 1, 2017 $ 4,500

Add cash rent received in 2017 15,000

Total $19,500

Less Unearned Rent balance at December 31, 2017 5,000

Rent Revenue for 2017 $14,500

3. Prepaid Insurance balance at January 1, 2017 $ 200

Add cash insurance paid in 2017 720

Total $ 920

Less Prepaid Insurance balance at December 31, 2017 120

Insurance Expense for 2017 $ 800

*Alternative solution using T-accounts:*

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1. Wages Payable | | | |  | Wages Expense | | | |
| Cash paid | 30,000 | Bal. (1/1/17) | 2,600 |  |  |  |  |  |
|  |  |  | *30,800* |  |  | *30,800* |  |  |
|  |  | Bal. (12/31/17) | 3,400 |  | Bal. (12/31/17) | 30,800 |  |  |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 2. Unearned Rent | | | |  | Rent Revenue | | | |
|  |  | Bal. (1/1/17) | 4,500 |  |  |  |  |  |
|  |  | Cash rec’d. | 15,000 |  |  |  |  |  |
|  | *14,500* |  |  |  |  |  |  | *14,500* |
|  |  | Bal. (12/31/17) | 5,000 |  |  |  | Bal. (12/31/17) | 14,500 |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 3. Prepaid Insurance | | | |  | Insurance Expense | | | |
| Bal. (1/1/17) | 200 |  |  |  |  |  |  |  |
| Cash paid | 720 |  |  |  |  |  |  |  |
|  |  |  | *800* |  |  | *800* |  |  |
| Bal. (12/31/17) | 120 |  |  |  | Bal. (12/31/17) | 800 |  |  |
|  |  |  |  |  |  |  |  |  |

**P 4-5(LO2, 3) Preparing Adjusting Entries, Posting, and Preparing Adjusted Trial Balance, and Financial Statements**

(a). Aug 31 Insurance Expense 1,200

Prepaid Insurance 1,200

Aug 31 Supplies Expense 2,400

Supplies 2,400

Aug 31 Depreciation Expense 1,725

Accumulated Depreciation-Buildings 1,125

Accumulated Depreciation-Equipment 600

Aug 31 Unearned Rent Revenue 4,100

Rent Revenue 4,100

Aug 31 Salaries and Wages Expense 400

Salaries and Wages Payable 400

Aug 31 Accounts Receivable 3,700

Rent Revenue 3,700

Aug 31 Interest Expense 600

Interest Payable 600

(b) SKYLINE Inc.

Adjusted Trial Balance

August 31, 2017

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Debit |  | Credit |
| Cash  Accounts Receivable  Supplies  Prepaid Insurance  Land  Buildings  Accumulated Depreciation—Buildings  Equipment  Accumulated Depreciation—Equipment  Accounts Payable  Unearned Rent Revenue  Salaries and Wages Payable  Interest Payable  Mortgage Payable  Capital Stock  Dividends  Rent Revenue  Maintenance and Repairs Expense  Supplies Expense  Depreciation Expense  Interest Expense  Insurance Expense  Salaries and Wages Expense  Utilities Expense |  | $ 19,600  3,700       900     4,800    25,000   125,000    26,000     5,000     3,600     2,400  1,725       600     1,200    51,400  9,400  $280,325 |  | $  1,125       600     6,500     3,300       400       600    80,000   100,000    87,800    $280,325 |

(c) SKYLINE Inc.

Statement of Comprehensive Income

For the Three Months Ended August 31, 2017

Revenues

Rent revenue $87,800

Expenses

Salaries and wages expense $51,400

Utilities expense   9,400

Maintenance and repairs expense   3,600

Supplies expense   2,400

Depreciation expense    1,725

Insurance expense   1,200

Interest expense     600

Total expenses 70,325

Net income $17,475

SKYLINE Inc.

Statement of Retained Earnings

For the Three Months Ended August 31, 2017

Retained Earnings, June 1 $     0

Add: Net income 17,475

 17,475

Less: Dividends 5,000

Retained Earnings, August 31 $12,475

SKYLINE Inc.

Balance Sheet

August 31, 2017

Assets

Current assets

Cash      $19,600

Accounts receivable      3,700

Supplies      900

Prepaid insurance    4,800

Total Current assets $29,000

Long-term assets

Equipment  $ 26,000

Less: Accum. depreciation—equipment 600 $25,400

Buildings 125,000

Less: Accum. depreciation—buildings 1,125  123,875

Land 25,000

Total Long-term assets $174,275

Total assets $203,275

Equity and Liabilities

Liabilities

Salaries and wages payable  $    400

Interest payable      600

Unearned rent revenue    3,300

Accounts payable   6,500

Mortgage payable 80,000

Total Liabilities $ 90,800

Equity

Capital Stock $100,000

Retained earnings      12,475

Total Equity 112,475

Total equity and liabilities $203,275

### P 4–6 (LO4) Account Classifications and Debit-Credit Relationships

(1) (2) (3) (4) (5)

B/S A, L, OE, Real or Closed Debit/

Account Title or S/CI R, E Nominal or Open Credit

Example: Cash B/S A Real Open Debit

1. Accounts Receivable B/S A Real Open Debit

2. Accounts Payable B/S L Real Open Credit

3. Prepaid Insurance B/S A Real Open Debit

4. Mortgage Payable B/S L Real Open Credit

5. Rent Expense S/CI E Nominal Closed Debit

6. Services Revenue S/CI R Nominal Closed Credit

7. Dividends Neither\* OE\* Nominal Closed Debit

8. Capital Stock B/S OE Real Open Credit

9. Retained Earnings B/S OE Real Open Credit

10. Prepaid Rent B/S A Real Open Debit

11. Supplies on Hand B/S A Real Open Debit

12. Utilities Expense S/CI E Nominal Closed Debit

13. Income Taxes Payable B/S L Real Open Credit

14. Interest Revenue S/CI R Nominal Closed Credit

15. Notes Payable B/S L Real Open Credit

16. Income Tax Expense S/CI E Nominal Closed Debit

17. Wages Payable B/S L Real Open Credit

18. Unearned Rent Revenue B/S L Real Open Credit

19. Land B/S A Real Open Debit

20. Unearned Consulting Fees B/S L Real Open Credit

21. Interest Receivable B/S A Real Open Debit

22. Consulting Fees S/CI R Nominal Closed Credit

\*Temporary account that does not appear on either the balance sheet or statement of comprehensive income, but that reduces the permanent equity account—Retained Earnings.

### P 4–7 (LO4) Closing Entries

1. Retained Earnings 16,400

Services Revenue 178,000

Salaries Expense 144,000

Interest Expense 10,500

Office Supplies Expense 7,640

Insurance Expense 9,860

Property Tax Expense 22,400

2. Retained Earnings 36,000

Dividends 36,000

### P 4–8 (LO4) Closing Entries

1. Services Revenue 276,100

Wages Expense 102,750

Utilities Expense 4,890

Insurance Expense 6,930

Property Tax Expense 10,510

Rent Expense 49,000

Advertising Expense 15,640

Interest Expense 9,800

Retained Earnings 76,580

2. Retained Earnings 18,600

Dividends 18,600

### P4–9(LO4) Preparing Closing Entries, and Preparing a Post-Closing Trial Balance

(a) Service Revenue 4,300

Retained Earnings 4,300

Retained Earnings 2,724

Salaries and Wages Expense 1,344

Miscellaneous Expense 180

Supplies Expense 1,200

Retained Earnings 300

Dividends 300

(b) SORA COMPANY

Post-Closing Trial Balance

For the Month Ended June 30, 2017

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Account Titles |  | Debit |  | Credit |

Cash $3,712

Accounts Receivable 2,904

Supplies 480

Accounts Payable $1,056

Salaries and Wages Payable 244

Unearned Service Revenue 160

Capital Stock 3,000

Retained Earnings              2,636

$7,096 $7,096

### P 4–10 (LO2, LO4) Unifying Concepts: Adjusting and Closing Entries

1. Supplies Expense 1,300

Supplies on Hand 1,300

Rent Expense 10,000

Prepaid Rent 10,000

Insurance Expense 885

Prepaid Insurance 885

Wages Expense 5,700

Wages Payable 5,700

Income Tax Expense 580

Income Taxes Payable 580

Interest Expense 600

Interest Payable 600

2. Consulting Fees Earned 142,380

Wages Expense 98,035

Rent Expense 10,000

Interest Expense 4,100

Insurance Expense 1,470

Supplies Expenses 5,665

Income Tax Expense 3,350

Retained Earnings 19,760

### P 4–11 (LO3, LO4) Unifying Con**cepts: Analysis of Ac**counts

1. Cash $ 61,000

Accounts Receivable 49,000

Furniture (net) 40,000

Inventory 160,000

Land 260,000

Supplies on Hand 10,000

Buildings (net) 240,000

Total assets $ 820,000

2. Services revenues $ 195,000

Salaries expense (50,000)

Net income $ 145,000

*Note:* Dividends are not an expense; they are a distribution of net income.

3. Since a beginning Retained Earnings balance is not known, the amount of ending Retained Earnings must be computed by using the basic accounting equation:

Assets = Liabilities + Equity

Total assets ($820,000) = Total liabilities ($120,000 + $250,000) +   
equity

Therefore, Equity at 12/31/17 = $450,000

Equity ($450,000) = Capital stock ($300,000) + Retained earnings(?)

Therefore, Retained Earnings at 12/31/17 = $(150,000)

4. If ending Retained Earnings is $(150,000) and net income for the period was $145,000, with $20,000 of Dividends, then beginning Retained Earnings must be $(25,000).

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Retained Earnings | | | | |
|  |  | Beg. bal | X=25,000 |
| Dividends | 20,000 | Net income | 145,000 |
|  |  | End. bal | 150,000 |
|  |  |  |  |

### P 4–12 (LO5) Unifying Concepts: Analysis and Correction of Errors

Assets = Liabilities + Equity

Reported balances $ 103,070 ≠ $ 53,300 + $ 76,300

(a) (9,000)

(b) 14,800 14,800

(c) 4,000 (4,000)

(d) (25,000) 25,000

(e) 17,530

Correct balances $ 135,400 = $ 47,100 + $ 88,300

### P 4–13 (LO5) Unifying Concepts: The Accounting Cycle

1. (a) Equipment 80,000

Accounts Payable 80,000

(b) Cash 10,000

Capital Stock 10,000

(c) Cash 80,000

Accounts Receivable 100,000

Services Revenue 180,000

(d) Notes Payable 35,000

Interest Expense 7,000

Cash 42,000

(e) Cash 105,000

Accounts Receivable 105,000

(f) Accounts Payable 95,000

Cash 95,000

(g) Salaries Expense 30,000

Cash 30,000

(h) Dividends 10,000

Cash 10,000

2. Entries (a) through (h) are derived from the solution to item 1. Closing   
entries (i) and (j) are derived from item 4.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Cash | | | |  | Accounts Receivable | | | |
| Beg. bal. | 15,000 | (d) | 42,000 |  | Beg. bal. | 20,000 | (e) | 105,000 |
| (b) | 10,000 | (f) | 95,000 |  | (c) | 100,000 |  |  |
| (c) | 80,000 | (g) | 30,000 |  |  |  |  |  |
| (e) | 105,000 | (h) | 10,000 |  |  |  |  |  |
| Updated bal. | 33,000 |  |  |  | Updated bal. | 15,000 |  |  |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Equipment | | | |  | Land | | | |
| Beg. bal. | 0 |  |  |  | Bal. | 180,000 |  |  |
| (a) | 80,000 |  |  |  |  |  |  |  |
| Updated bal. | 80,000 |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Accounts Payable | | | |  | Notes Payable | | | |
| (f) | 95,000 | Beg. bal. | 25,000 |  | (d) | 35,000 | Beg. bal. | 35,000 |
|  |  | (a) | 80,000 |  |  |  | Updated bal. | 0 |
|  |  | Updated bal. | 10,000 |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Capital Stock | | | |  | Retained Earnings | | | |
|  |  | Beg. bal. | 125,000 |  | (j) | 10,000 | Beg. bal. | 30,000 |
|  |  | (b) | 10,000 |  |  |  | (i) | 143,000 |
|  |  | Updated bal. | 135,000 |  |  |  | Updated bal. | 163,000 |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Dividends | | | |  | Services Revenue | | | |
| (h) | 10,000 | (j) | 10,000 |  | (i) | 180,000 | (c) | 180,000 |
| Updated bal. | 0 |  |  |  |  |  | Updated bal. | 0 |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Interest Expense | | | |  | Salaries Expense | | | |
| (d) | 7,000 | (i) | 7,000 |  | (g) | 30,000 | (i) | 30,000 |
| Updated bal. | 0 |  |  |  | Updated bal. | 0 |  |  |
|  |  |  |  |  |  |  |  |  |

3. Anderson Company

Statement of Comprehensive Income

For the Year Ended December 31, 2017

Services revenue $180,000

Expenses:

Salaries expense $30,000

Interest expense 7,000 37,000

Net income $ 143,000

Other comprehensive income 0

Comprehensive income $ 143,000

Anderson Company

Balance Sheet

December 31, 2017

Assets

Cash $ 33,000

Accounts receivable 15,000

Equipment 80,000

Land 180,000

Total assets $308,000

Liabilities and Equity

Liabilities:

Accounts payable $ 10,000

Equity:

Capital stock $135,000

Retained earnings 163,000\*

Total equity $298,000

Total liabilities and equity $308,000

\*See statement of retained earnings.

Anderson Company

Statement of Retained Earnings

December 31, 2017

Retained earnings (January 1) $30,000

Add: Net income for 2017 143,000

$173,000

Less: Dividends for 2017 10,000

Retained earnings (December 31) $163,000

4. (i) Services Revenue 180,000

Salaries Expense 30,000

Interest Expense 7,000

Retained Earnings 143,000

(j) Retained Earnings 10,000

Dividends 10,000

5. Anderson Company

Post-Closing Trial Balance

December 31, 2017

Debits Credits

Cash $ 33,000

Accounts Receivable 15,000

Equipment 80,000

Land 180,000

Accounts Payable $ 10,000

Capital Stock 135,000

Retained Earnings 163,000

Totals $308,000 $308,000

## ANALYTICAL ASSIGNMENTS

AA 4–1 Using Financial Statements for Investment Decisions

Discussion

In completing this analysis, accounts may be set up, journal entries made and posted to the accounts, and the financial statements drawn from the adjusted year-end account balances, as follows:

Real Estate Business

Balance Sheet

At Year-End

Assets

Cash in bank $30,700

Commissions receivable 1,000

Notes receivable 10,000

Supplies on hand 300

Prepaid office rent 1,500

Total assets $43,500

Liabilities and Equity

Accounts payable $ 300

Equity 43,200\*

Total liabilities and equity $43,500

\*The balance in the equity account results from the beginning balance $22,600 plus the net income for the year $20,600, as shown in the following T-account:

|  |  |  |  |
| --- | --- | --- | --- |
| EQUITY | | | |
|  |  | Beg. bal. | 22,600 |
|  |  | Net income | 20,600 |
|  |  | Updated bal. | 43,200 |
|  |  |  |  |

AA 4–1 (Continued)

Real Estate Business

Statement of Comprehensive Income

For the Current Year

Revenues:

Commissions revenue $45,500

Interest revenue 1,200 $46,700

Expenses:

Supplies expense $ 950

Office rent expense 3,000

Utilities expense 1,500

Miscellaneous office expense 250

Salaries and wages expense 20,400 26,100

Net income $20,600

Other comprehensive income 0

Comprehensive income $20,600

The business appears profitable since the net income is positive. The balance sheet also presents a positive financial picture. The business has significant cash relative to total assets, and its relationship of current assets to current liabilities (current ratio) is very positive. One potential concern is the collectibility of the note receivable, which is almost one-fourth of total assets. The doctors would want to look at the cash flows of the business (i.e., cash flow statement) as well as compare the current year results with other years to see if the financial trends are as positive as the current results. The doctors would also want to consider alternative investments to see if this venture would be the best use of their investment dollars.

AA 4–2 Accounting and Ethical Issues Involving the Closing Process

Discussion

The main accounting issue is proper cutoff of the accounting period. In this case, Year-Round Landscape, Inc., has a December 31 year-end. Only transactions for the current accounting period should be included. The major contract to be signed on January 3 is a transaction properly accounted for in the next fiscal period.

Revenues are to be recognized (recorded) when the earnings process is completed and when objective evidence exists as to the amounts involved, e.g., when an arm’s-length transaction has occurred. In this case, as mentioned above, the transaction occurs in the next period (e.g., when the contract is signed). The earnings process is likely to occur during the next fiscal period as well—when the services for the contract are provided.

The primary ethical issue involved in this case is the proposed deliberate misrepresentation of operating results for Year-Round Landscape, Inc., if the books are not properly closed on December 31.

Also, even if the books are held open for a week, as Silva suggests, it would not be appropriate to increase this year’s earnings by 20% unless all services for the major contract were performed in that one-week period, which is unlikely. Revenue should not be reported until it is earned, as indicated before. Silva should resist the temptation to make Year-Round Landscape’s results look better than they actually are.

AA 4–3 Home Depot

**Real Company Analysis**

***(in millions)***

**1.** Retained earnings, 2/3/2013 $20,038

Add: Net income for the year 5,385

Less: Dividends for the year (2,243)

Retained earnings, 2/2/2014 $23,180

Add: Net income for the year 6,345

Less: Dividends for the year (2,530)

Retained earnings, 2/1/2015 $26,995

Add: Net income for the year 7,009

Less: Dividends for the year (3,031)

Retained earnings, 1/31/2016 $30,973

**2.** Dividend Payout Ratio

2014 41.65% ($2,243/$5,385)

2015 39.87% ($2,530/$6,345)

2016 43.24% ($3,031/$7,009)

Comparing with 2014, Home Depot’s dividend payout ratio decreased in 2015 and increased in 2016.

AA 4–4 Do Two Wrongs Make a Right?

Ethics

This ethics case illustrates that in many cases accountants are not dealing with someone who is lying, cheating, or stealing. In this instance, Jex has elected to account for certain items a little differently. There is no criminal intent on his part. In fact, Jex’s argument for comparability is quite compelling. One of the major uses of financial statement information is to compare the performance of a company across time and across other firms in the same industry.

But the fact remains that the unearned revenue is just that—unearned. It should not be reported as revenue in this year. In addition, the $350,000 of revenue that was earned in January of this year, yet reported last year, should be corrected. The fact that the same error was made twice does not justify the error.

The adjusting entry required at year-end to account for the $400,000 of unearned revenue would be:

Revenue 400,000

Unearned Revenue 400,000

In addition, a journal entry should be made to correct for the error made last year. That is, $350,000 of revenue recognized last year should be recognized this year. The journal entry to accomplish this would be:

Retained Earnings 350,000

Revenue 350,000

Why the debit to Retained Earnings? If you think about it, it makes sense. The revenue was erroneously recorded last year and then closed to Retained Earnings. We need to get it out of Retained Earnings, which is accomplished with a debit.