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5TH EDITION
FINANCIAL
ACCOUNTING
WITH INTERNATIONAL FINANCIAL
REPORTING STANDARDS
WILEY

Financial Accounting

with International Financial Reporting Standards

Fifth Edition

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WILEY

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Author Commitment



JERRY J. WEYGANDT, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in *The Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting texts and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the Accounting Review; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Educator Award.



PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He was an Associate Professor at the University of Wisconsin—Milwaukee for more than 25 years and is now a Senior Lecturer at the University of Wisconsin—Madison. He has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award and the Reggie Taite Excellence in Teaching Award, and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review, Accounting Horizons, Advances in Management Accounting, Managerial Finance, Issues in Accounting Education*, and *Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education.

New to This Edition: Data Analytics

The authors carefully considered how to thoughtfully and meaningfully integrate data analytics into the financial accounting course, and are pleased to provide the following data analytics resources.

Data Analytics and Decision-Making

The text provides numerous discussions on how decision-makers are increasingly relying on data analytics to make decisions using accounting information.

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies.

Data Analytics in the Real World

Real-world examples that illustrate engaging situations in companies are provided throughout the text.

Data Analytics Insight Netflix



boumenjapet/Adobe Stock

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And Netflix (USA), the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et. al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making? (Answer is available near the end of the chapter.)

Data Analytics in Action

Data Analytics in Action problems provide students with the opportunity to see how to use data analytics to help solve realistic business problems.

- **PowerBI and Tableau visualizations** accompanied by assignable questions are available with most chapters. PowerBI and Tableau visualizations allow students to interpret visualizations and think critically about data.
- **Excel-based data analytics problems** are also available for most chapters. The accompanying Excel templates provide students with a framework for solving the problem.

Data Analytics in Excel videos provide students with step-by-step guidance to perform the Excel skills they need to solve these problems.

Data Analytics in Action

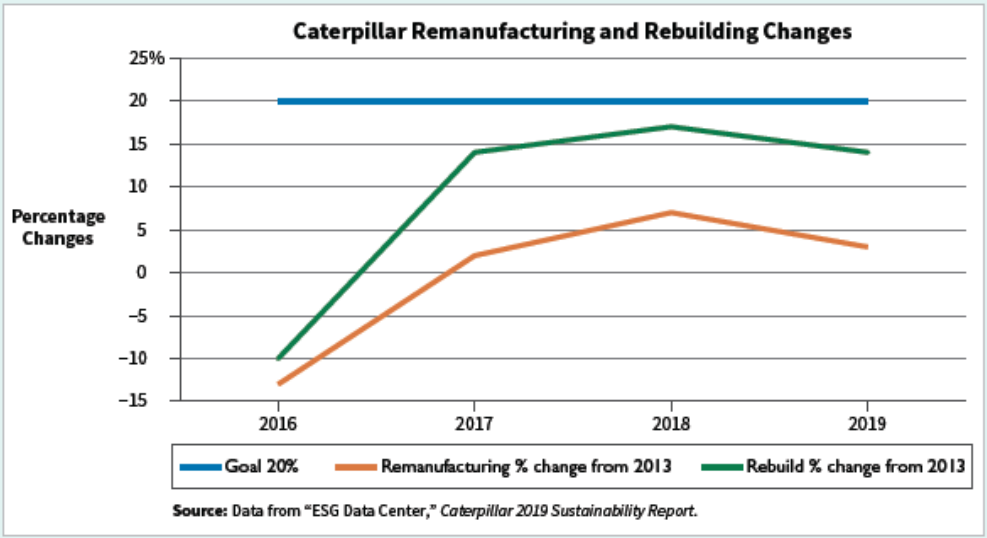
Using Data Visualization to Analyze Changes over Time

DA6.1 Data visualization can be used to analyze company changes over time.

Example: Recall the Feature Story "Where Is That Spare Bulldozer Blade?" presented in the chapter. One competitor to **Komatsu Ltd.** (JPN) is **Caterpillar** (USA), which continues to enhance its inventory management by improving its product sustainability in two ways. First, it is rebuilding used parts to like-new condition. Second, the company is remanufacturing usable inventory parts when customers trade-in or dispose of their used equipment. These actions not only reduce inventory costs but also enable Caterpillar to participate in the circular economy, where manufacturers take responsibility for their products at the end of the product lives. As noted in its 2019 sustainability report, Caterpillar has a goal of 20% growth in both rebuilding and remanufacturing.

Excel

Has Caterpillar reached this goal? A line chart can help you visualize the company's progress over time. What information can you obtain by examining the following chart?



Source: Data from "ESG Data Center," *Caterpillar 2019 Sustainability Report.*

The chart indicates that while Caterpillar's goal has remained at 20%, the remanufacturing and rebuilding businesses are growing. The biggest increase in the growth of rebuilding occurred from 2016 to 2017. There was a decline from 2018 to 2019 in these initiatives as Caterpillar may have reached a peak that is leveling off due to new production that is more sustainable.

For this case, you will look more closely at specific Caterpillar data regarding its end-of-life returned materials and the percentage usable for recycling. You will create and analyze a combination column and line chart to determine how Caterpillar can increase its gross profit as it relates to these end-of-life materials.

Go to the Wiley online course for complete case details and instructions.

Using Data Analytics to Compare Companies' Inventory Turnover

DA6.2 Inventory turnover shows the number of times during the period a firm sells the entire financial value of its inventory. It is advantageous to turn over inventory more quickly to reduce the risk of obsolescence and spoilage. As such, companies often have a goal of increasing inventory turnover. For this case, you will use inventory turnover data for U.S. companies **Costco**, **Walmart**, **Target**, and **Amazon** to create and analyze scatter plots, as well as to calculate days' sales in inventory, to determine which company is managing its inventory levels most effectively.

Excel

Go to the Wiley online course for complete case details and instructions.

Data Analytics Module

An **accounting-specific data analytics module** with interactive lessons, case studies, and videos is part of the Wiley online course. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the changing workforce.

New to This Edition

The last few years have brought many changes to the teaching and learning environment. As a result, we scrutinized every chapter of *Financial Accounting* to make sure our text best meets the needs of today's students and instructors. The most significant changes throughout the text include:

- NEW discussion of data analytics integrated throughout the text, at an appropriate level of detail for introductory accounting students.
- NEW Data Analytics assignments at the end of selected chapters.
- MORE bulleted/numbered lists within the text discussion, to highlight key information for students.
- UPDATED fair value principle and historical cost principle to current value basis/historical cost basis per recent IFRS throughout.
- ADDED Answers to Insight box questions near the end of each chapter.

Chapter-by-Chapter Changes

Chapter 1: Accounting in Action

- NEW discussion of how financial statement users can employ data analytics to improve decision-making.
- NEW discussion on the current value basis, and updated discussion of historical cost basis, per recent IFRS.
- NEW Helpful Hint on the two concepts of income under IFRS: net income and comprehensive income.
- NEW Data Analytics Insight, on how **Netflix** uses data analytics to estimate costs for future productions.
- NEW Ethics Insight, on the financial frauds that occurred at **Toshiba**.

Chapter 2: The Recording Process

- NEW Helpful Hint, to reinforce student understanding of journals.

Chapter 3: Adjusting the Accounts

- NEW discussion, illustration, and end-of-chapter assignments of the five-step revenue recognition process.
- NEW Helpful Hint, on how adjusting entries have no effect on cash flows.
- UPDATED discussion for historical cost and current value bases.
- UPDATED Environmental, Social, and Governance (ESG) Insight on disposing of electronics safely.

Chapter 4: Completing the Accounting Cycle

- UPDATED discussion of worksheet to put its use more in context of the accounting cycle.
- NEW discussion of recent technology (robotic process automation) used in the closing process.
- UPDATED definitions of current assets and current liabilities per most recent IFRS.
- NEW Accounting Across the Organization boxes on (1) using robots and process mining for routine accounting tasks and (2) liquidity management during Covid-19.

Chapter 5: Accounting for Merchandising Operations

- NEW section, "Data Analytics and Credit Sales," on how companies use data analytics to improve business decision-making regarding their policies on credit sales, sales returns and allowances, and sales discounts.
- EXPANDED discussion of FOB shipping point/FOB destination to ensure student understanding.
- NEW Appendix 5C, "Adjusting Entries for Credit Sales with Returns and Allowances," and related EOC material.
- NEW Accounting Across the Organization box on how **Alibaba** uses personalized shopping pages to increase its e-commerce presence and revenue.
- UPDATED discussion of fair value to current value/net realizable value throughout.
- NEW Data Analytics in Action end-of-chapter problem on using data visualizations to analyze companies' profitability.

Chapter 6: Inventories

- NEW discussions on (1) write-down reversals and (2) how data analytics can benefit inventory management.
- NEW Data Analytics Insight on effectiveness of dashboards.
- NEW Accounting Across the Organization box on fashion companies' innovative methods for handling deadstock.
- UPDATED Accounting Across the Organization box ("A Big Hiccup") to include Covid-19 impacts on global automotive manufacturers.
- NEW illustration showing **Walmart**'s recent inventory disclosure, using the retail inventory method.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to analyze companies over time and data analytics to compare companies' inventory turnover.
- NEW end-of-chapter case on inventory theft.

Chapter 7: Fraud, Internal Control, and Cash

- NEW section on how data analytics helps improve internal controls.
- UPDATED discussion of over-the-counter, electronic, and check receipts per recent technology.
- UPDATED discussion of electronic banking per recent technology.
- UPDATED discussion of cash equivalents and restricted cash per recent standards.
- NEW Anatomy of a Fraud boxes on fraud due to the missing control of segregation of duties.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to help understand fraud and using data analytics to determine the impact of internal control activities.
- NEW end-of-chapter cases on blockchain technology and the IASB.

Chapter 8: Accounting for Receivables

- NEW section on data analytics and receivables management.
- NEW Data Analytics Insight on using data analytics to help with credit decisions and estimating uncollectible accounts.
- NEW discussion of IASB expected credit loss model, which requires that companies measure expected uncollectible accounts and record bad debt expense on all receivables, even those with a low risk of loss.
- NEW Data Analytics in Action end-of-chapter problems on using data visualization to analyze bad debts over time and using data analytics to evaluate notes receivables over time.

Chapter 9: Plant Assets, Natural Resources, and Intangible Assets

- UPDATED definition of depreciation.
- NEW Data Analytics in Action end-of-chapter problem on using data visualization to analyze assets.

Chapter 10: Current Liabilities

- NEW Accounting Across the Organization box on whether **SAP**'s growing deferred income account is a good sign or bad.
- NEW end-of-chapter case on how Covid-19 has impacted microfinancing.

Chapter 11: Non-Current Liabilities

- NEW Investor Insight on how **Volkswagen** issued debt to manage developing electric vehicles as well as Covid-19 issues, and the implications of that for the company's future.

Chapter 12: Corporations: Organization, Share Transactions, and Equity

- NEW discussion on hybrid forms of business organization.
- UPDATED discussion of statement of changes in equity, as now a required statement.
- NEW ESG Insight box on the upward trend of shareholder proposals on corporate responsibility.
- NEW Investor Insight, on how companies that pay dividends can increase investor wealth.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to compare share prices and data analytics to compare the effect of share splits.

Chapter 13: Investments

- NEW discussions on (1) the classification and measurement of investments, (2) accounting for bonds both to hold and to sell, (3) using fair value to account for share investments of less than 20%, and (4) accounting for debt investments classified as held-for-collection and selling.
- UPDATED discussion to include the three (previously two) categories of securities.

Chapter 14: Statement of Cash Flows

- NEW Accounting Across the Organization box on how companies are moving away from hypergrowth and instead focusing on growing profits and cash flows.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations and data analytics to analyze cash flows.

Chapter 15: Financial Statement Analysis

- UPDATED to include more bulleted lists to facilitate student understanding.

Proven Pedagogical Features

In this new edition, all content has been carefully reviewed and revised to ensure maximum student understanding. At the same time, the time-tested features that have proven to be of most help to students have been retained, such as the following.

Infographic Learning

Over half of the text is visual, providing students alternative ways of learning about accounting.

ILLUSTRATION 6.9 Allocation of costs—average-cost method

Cost of Goods Available for Sale

Date	Explanation	Units	Unit Cost	Total Cost
Jan. 1	Beginning inventory	10	HK$100	HK$ 1,000
Apr. 15	Purchase	20	110	2,200
Aug. 24	Purchase	30	120	3,600
Nov. 27	Purchase	40	130	5,200
	Total	100		HK$12,000

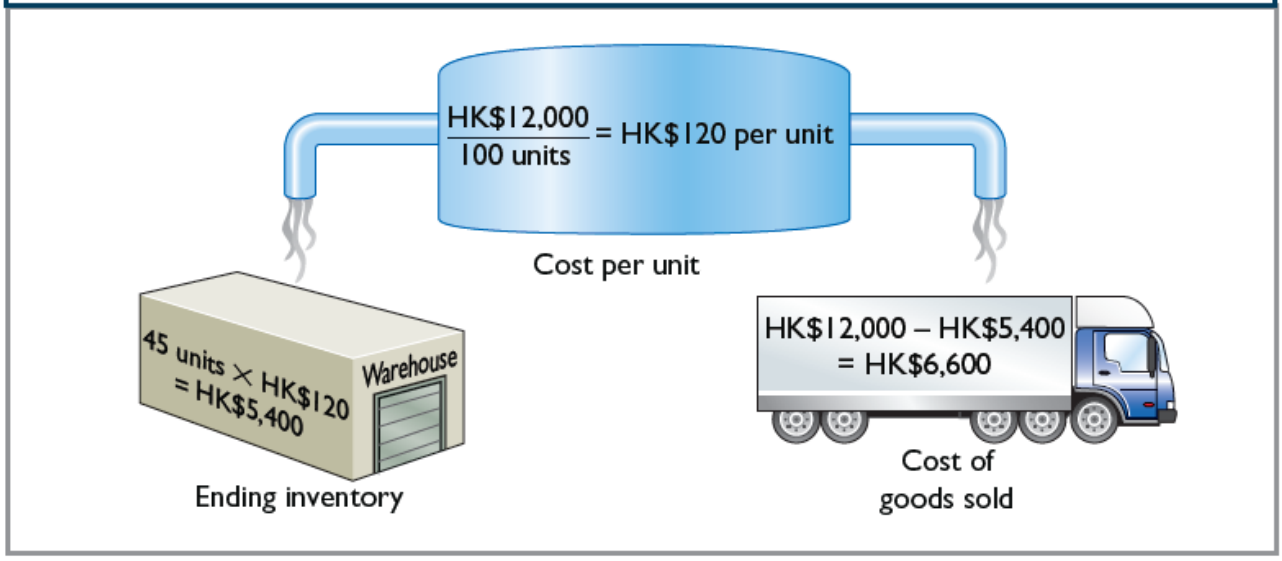
Step 1: Ending Inventory

HK$12,000 ÷ 100 = HK$120

Units	Unit Cost	Total Cost
45	HK$120	HK$5,400

Step 2: Cost of Goods Sold

Cost of goods available for sale	HK$12,000
Less: Ending inventory	5,400
Cost of goods sold	HK$ 6,600



Real-World Decision-Making

Real-world examples, which illustrate engaging situations in companies, are provided throughout the text. Answers to the critical thinking questions posed to readers within the real-world examples are now available near the end of each chapter.

Environmental, Social, and Governance Insight



Nathan Gleave/Getty Images

Got Junk?

Do you have an old computer or two in your garage? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete **each day**. Yet, in a recent year, only 11% of computers were recycled.

It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.

What accounting issue might this cause for companies? (Answer is available near the end of the chapter.)

DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

ACTION PLAN

- Make adjusting entries at the end of the period to recognize revenues for services performed and for expenses incurred.
- Don't forget to make adjusting entries for accruals. Adjusting entries for accruals will increase both a statement of financial position and an income statement account.

DO IT! 3 | Adjusting Entries for Accruals

Mahindra Computer Services began operations on August 1, 2025. At the end of August 2025, management prepares monthly financial statements. The following information relates to August (amounts in thousands).

1. At August 31, the company owed its employees ₹800 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed ₹30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
3. Revenue for services performed but unrecorded for August totaled ₹1,100.

Prepare the adjusting entries needed at August 31, 2025.

Solution

1.	Salaries and Wages Expense	800	
	Salaries and Wages Payable		800
	(To record accrued salaries)		
2.	Interest Expense	250	
	Interest Payable		250
	(To record accrued interest: ₹30,000 × 10% × $\frac{1}{12}$ = ₹250)		
3.	Accounts Receivable	1,100	
	Service Revenue		1,100
	(To record revenue for services performed)		

Related exercise material: **BE3.9, DO IT! 3.3, E3.5, E3.6, E3.7, E3.8, E3.9, and E3.10.**

Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, Decision Tools review, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

Review and Practice

Practice Brief Exercises

Indicate why adjusting entries are needed.

1. **(LO 1)** The ledger of Dey Company includes the following accounts. Explain why each account may need adjustment.

   a. Supplies.
   b. Unearned Service Revenue.
   c. Salaries and Wages Payable.
   d. Interest Payable.

Solution

1. **a.** Supplies: to recognize supplies used during the period.
   b. Unearned Service Revenue: to record revenue generated for services performed.
   c. Salaries and Wages Payable: to recognize unpaid salaries and wages due to employees at the end of a reporting period.
   d. Interest Payable: to recognize interest accrued but unpaid on notes payable.

Prepare adjusting entry for depreciation.

2. **(LO 2)** At the end of its first year, the trial balance of Denton Cleaners shows Equipment of £40,000 and zero balances in Accumulated Depreciation—Equipment and Depreciation Expense. Depreciation for the year is estimated to be £8,000. Prepare the adjusting entry for depreciation at December 31, post the adjustments to T-accounts, and indicate the statement of financial position presentation of the equipment at December 31.

Solution

2.

Dec. 31	Depreciation Expense		8,000	
	Accumulated Depreciation—Equipment			8,000

Depreciation Expense			Accum. Depreciation—Equipment		
12/31	8,000			12/31	8,000

Statement of financial position:

Equipment	£40,000	
Less: Accumulated depreciation—equipment	8,000	
		£32,000

Prepare adjusting entries for accruals.

3. **(LO 3)** You are asked to prepare the following accrual adjusting entries at December 31.

   1. Services performed but not recorded are €4,200.
   2. Utilities expenses incurred but not paid are €660.
   3. Salaries and wages earned by employees of €3,000 are unpaid.

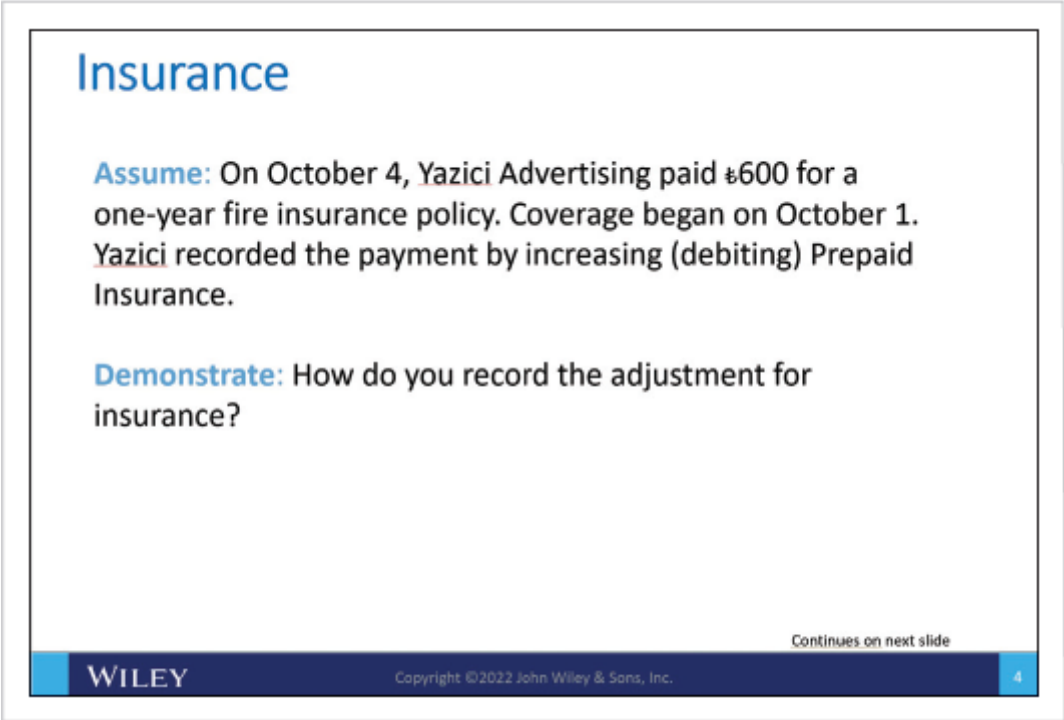
   Use the following account titles: Accounts Receivable, Service Revenue, Salaries and Wages Expense, Salaries and Wages Payable, Utilities Expense, and Utilities Payable.

Engaging Digital Tools

Digital study tools in Wiley's online course include the following.

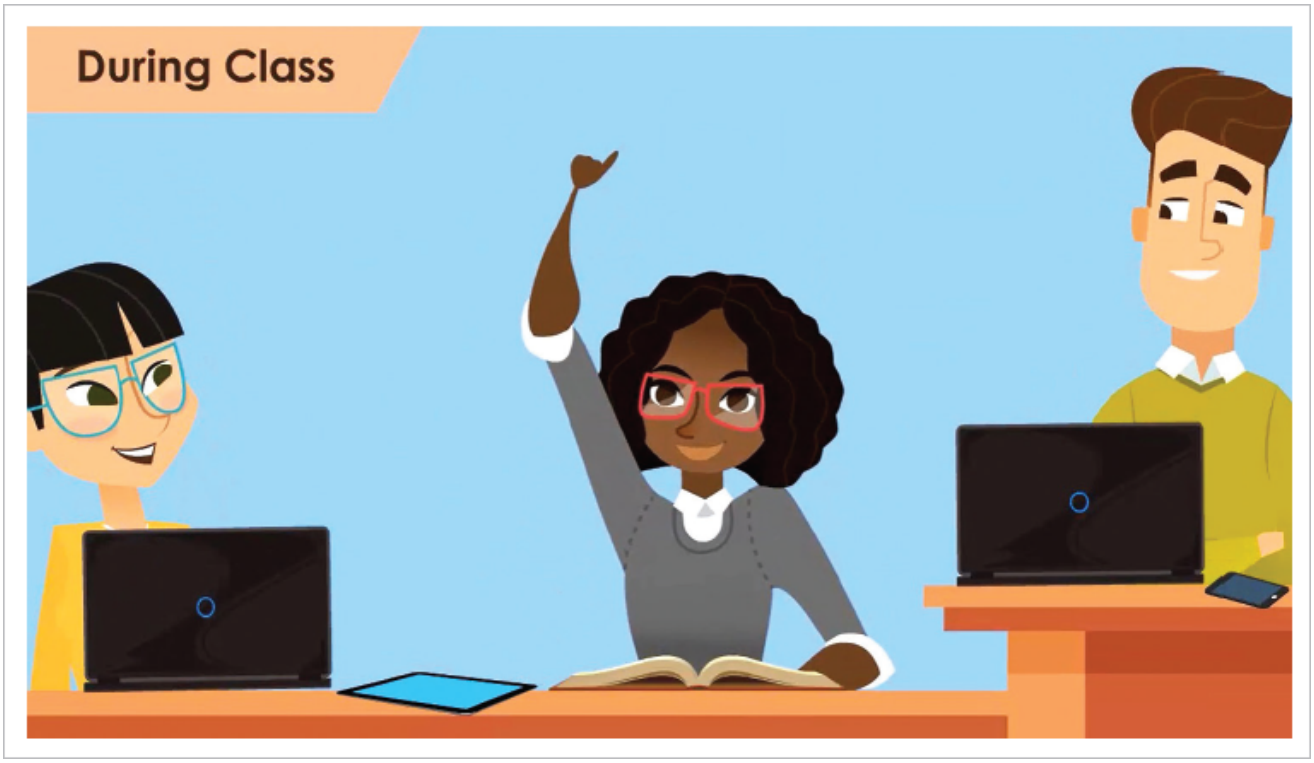
Lecture PowerPoints

Lecture PowerPoints break down each section and learning objective in the text. The slides simplify major concepts in the text, making the concepts easier to understand. They provide additional explanation for activities, images, and figures to enhance student learning.



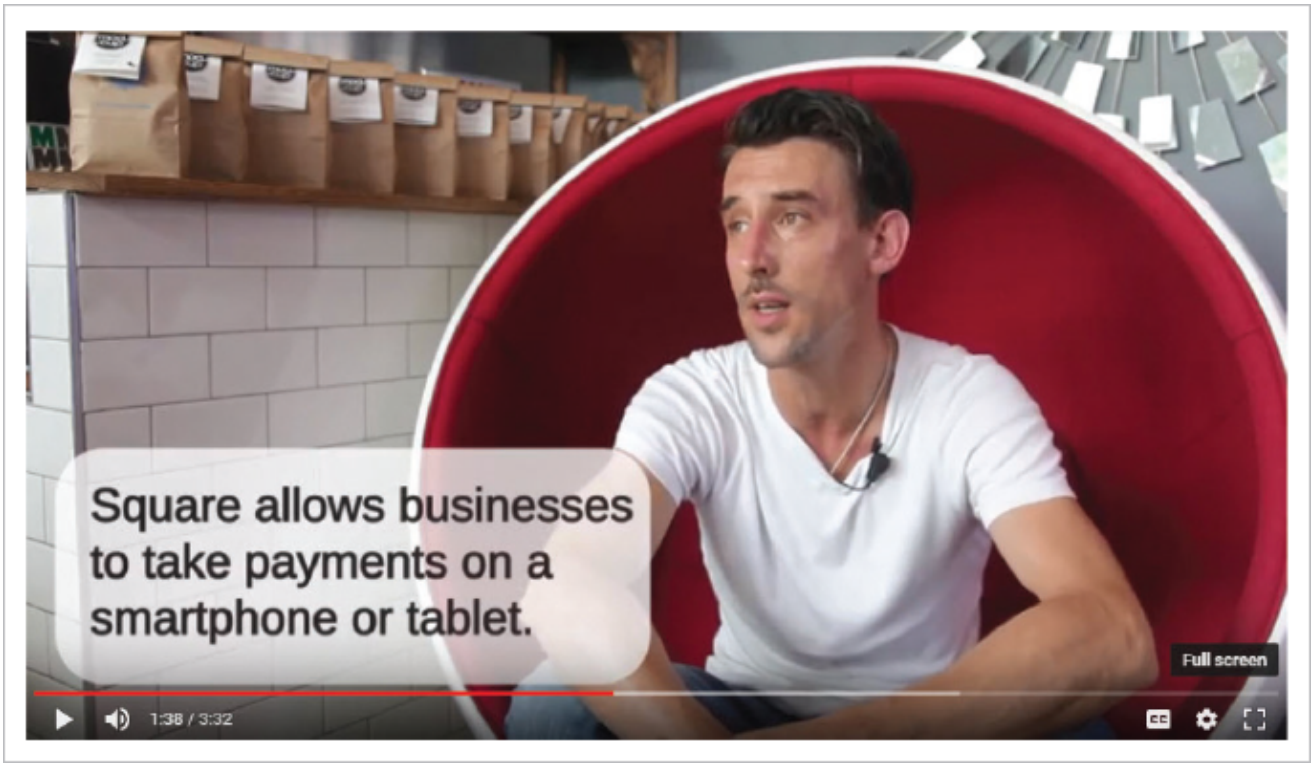
Accounting Animated Shorts

Short, animated videos engage students and simplify major concepts in the text, making the concepts easier to understand. They offer an alternative approach to understanding the written material.



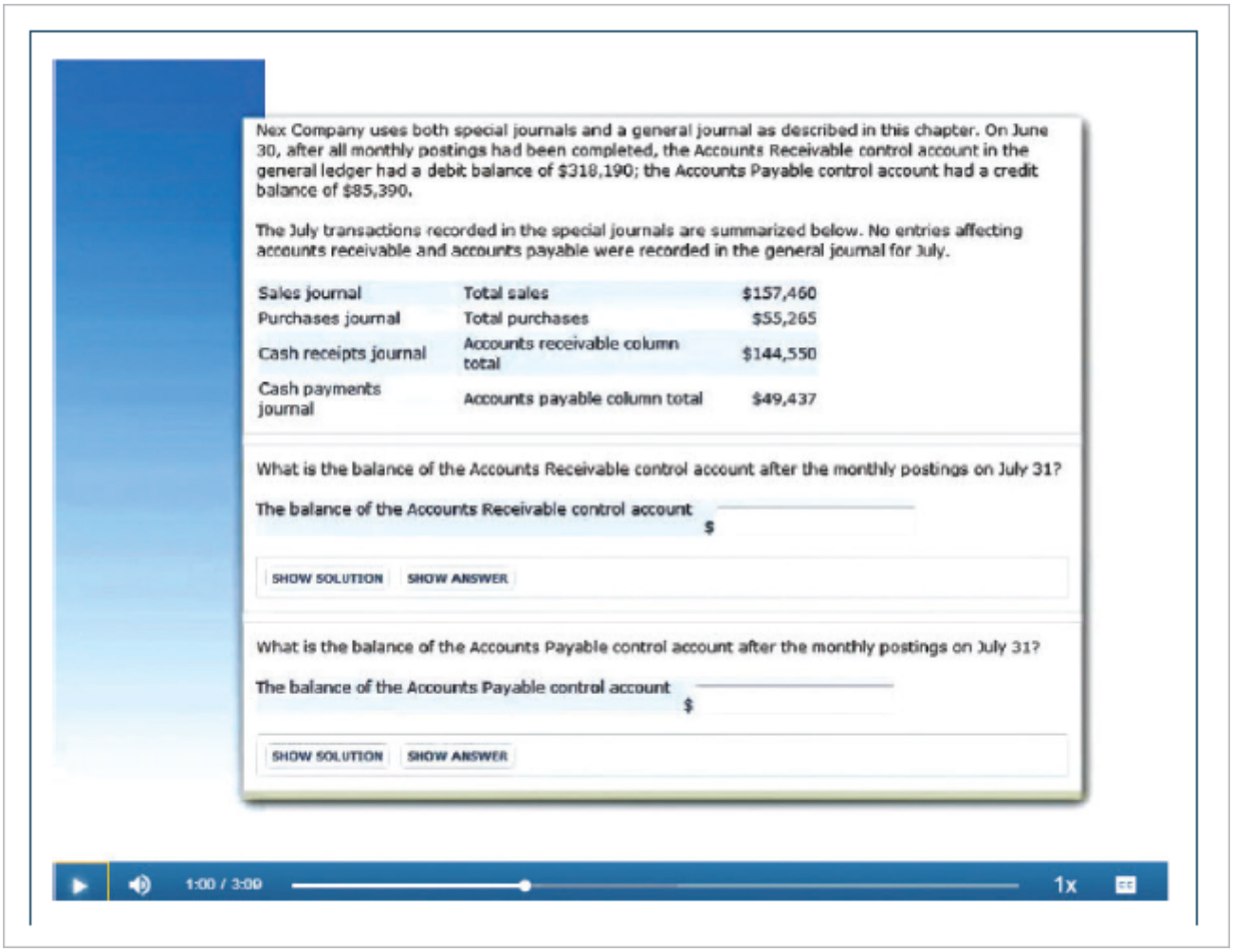
Real-World Videos

Real-world videos feature both small businesses and larger companies to help students apply content and see how business owners apply concepts from the text in the real world. Many of the videos have associated questions available to be assigned.



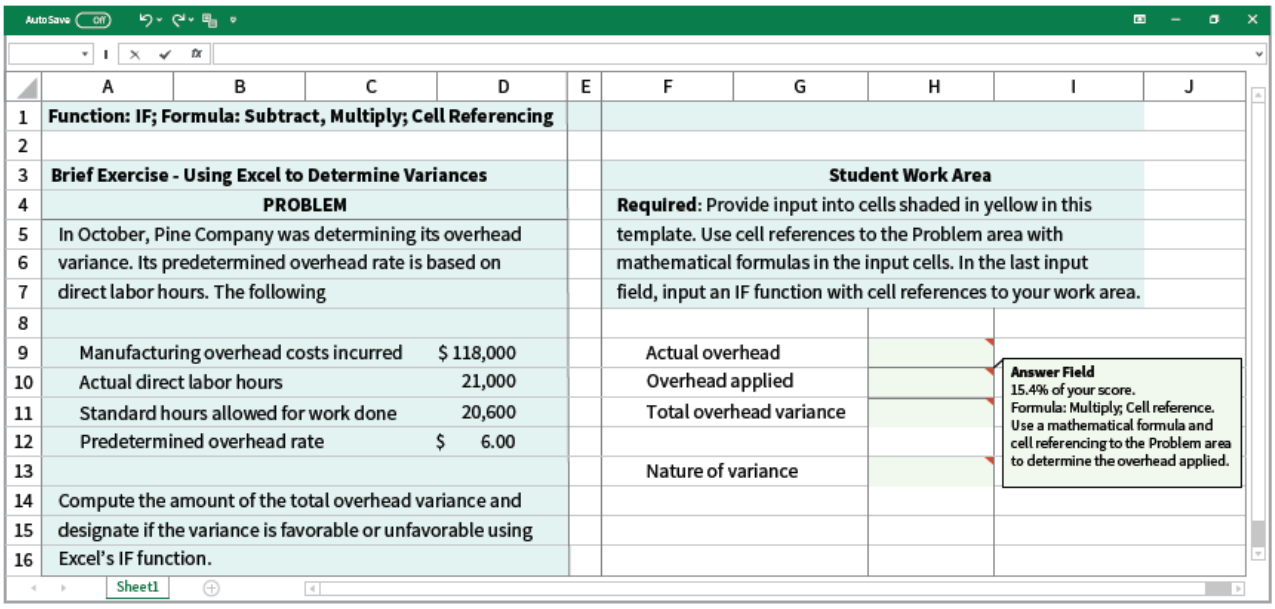
Solution Walkthrough Videos

Solution Walkthrough Videos are available as question assistance and to help students develop problem-solving techniques. These videos walk students through solutions step-by-step and are based on the most regularly assigned exercises and problems in the text.



Gradable Excel Questions

Gradable Excel questions provide students an opportunity to practice Excel skills in the context of solving accounting problems.



Other Learning Opportunities

Other learning opportunities in Wiley's online course include the following.

- **Accounting-Specific Data Analytics Module** offers interactive lessons, case studies, and videos. The module has been prepared using industry-validated content to help students

develop the professional competencies needed for the changing workforce.

- **Matcha Creations** is a continuing case that spans across chapters and offers students the opportunity to see how a small business might use financial accounting to operate effectively.
- **Wiley Accounting Updates** (wileyaccountingupdates.com) provide faculty and students with weekly curated news articles and suggested discussion questions.
- **Flashcards and Crossword Puzzles** help students study and master basic vocabulary and concepts.
- **Student Practice** quickly and effectively assesses student understanding of the material they have just covered.

Thank You

Meet Our Contributor

In this new edition of *Financial Accounting*, the authors are pleased to welcome the assistance of Jack Cathey. A professor at the University of North Carolina—Charlotte, Jack assisted the authors with updating chapter content per the most recent IFRS as well as the current accounting environment. He also ensured that the company references are the most relevant and relatable to the student, focusing on well-known companies with tangible examples.

Additional Acknowledgments

Financial Accounting has benefited greatly from the input of those who have sent comments by letter or email, ancillary authors, and proofers. We greatly appreciate the constructive suggestions and innovative ideas of reviewers and the creativity and accuracy of the ancillary authors and checkers.

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Finally, we appreciate suggestions and comments from users—instructors and students alike. We welcome your thoughts and ideas about the text.

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CHAPTER 1
Accounting in Action



Erik Isakson/Tetra Images/AGE Fotostock

*The **Chapter Preview** describes the purpose of the chapter and highlights major topics.*

Chapter Preview

The following Feature Story highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.*

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" In response, consider the quote from Harold Geneen, the former chairman of a major international company: "To be good at your business, you have to know the numbers—cold."

Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting is the means for communicating the numbers. If you don't know how to read financial statements, you cannot really know your business.

Many companies spend significant resources teaching their employees basic accounting so that they can read financial statements and understand how their actions affect the company's financial results. Employers need managers in all areas of the company to be "financially literate."

Taking this course will go a long way to making you financially literate. In this text, you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results.

Appendices A, B, and C of this text provide real financial statements of three companies from different countries that report using International Financial Reporting Standards (IFRS): **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN), **Nestlé SA** (CHE), and **Delfi Limited** (SGP). Throughout this text, we increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements. In addition, we encourage you to visit each company's website where you can view its complete annual report.

Even though these three companies are based in three different countries, they all follow IFRS. This means they all follow the same basic accounting principles. As a result, their financial statements are very similar. Therefore, by learning these basic principles as presented in this text, you will be well equipped to begin understanding the financial results of companies around the world.

*The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.*

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Identify the activities and users associated with accounting.	• Who uses accounting data • Data analytics	**DO IT! 1** Basic Concepts
LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.	• Ethics in financial reporting • Accounting standards • Measurement principles • Assumptions	**DO IT! 2** Building Blocks of Accounting
LO 3 State the accounting equation, and define its components.	• Assets • Liabilities • Equity	**DO IT! 3** Equity Effects
LO 4 Analyze the effects of business transactions on the accounting equation.	• Accounting transactions • Transaction analysis • Summary of transactions	**DO IT! 4** Tabular Analysis
LO 5 Describe the five financial statements and how they are prepared.	• Income statement • Retained earnings statement • Statement of financial position • Statement of cash flows • Comprehensive income statement	**DO IT! 5** Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a targeted summary and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

1.1 Accounting Activities and Users

> **LEARNING OBJECTIVE 1**
>
> Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? Accounting.[1] Why do people choose accounting? They want to acquire the skills needed to understand what is happening financially inside an organization. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users.

1. As a starting point to the accounting process, a company identifies the **economic events relevant to its business**. Examples of economic events are the sale of food and snacks by **Unilever** (GBR), the providing of telephone services by **Chunghwa Telecom** (TWN), and the manufacture of motor vehicles by **Tata Motors** (IND).
2. Once a company like Unilever identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in monetary units. In recording, Unilever also classifies and summarizes economic events.
3. Finally, Unilever **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**.

***Essential terms** are printed in blue when they first appear, and are defined in the end-of-chapter **Glossary Review**.*

To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, Unilever accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information.

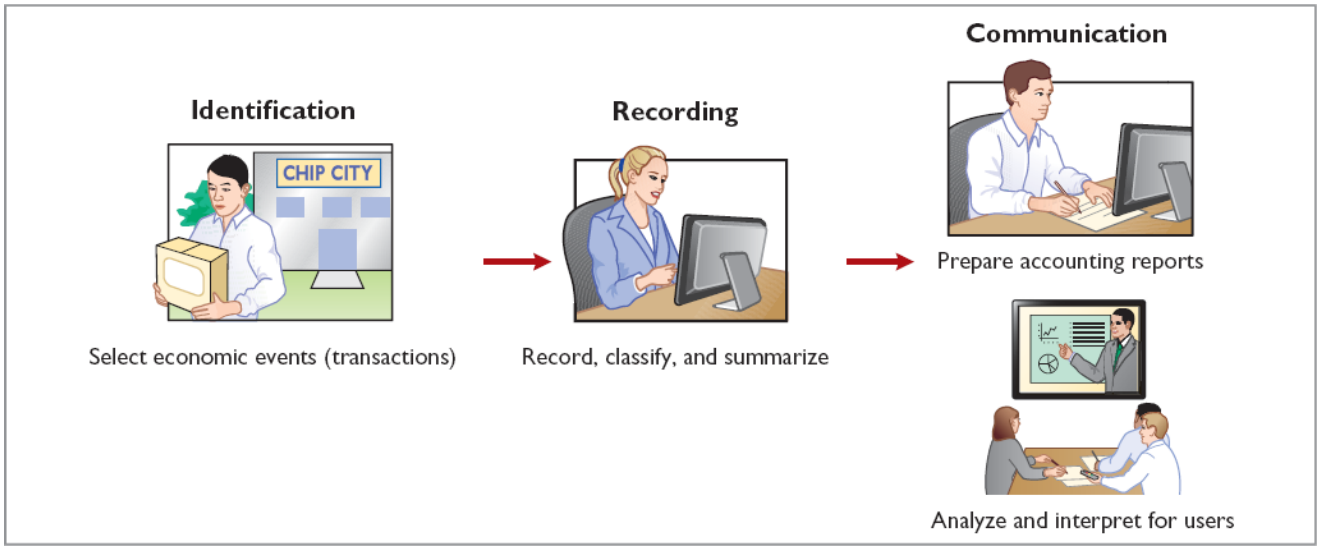
- Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships.
- Interpretation involves **explaining the uses, meaning, and limitations of reported data**.

Appendix A of this text shows the financial statements of **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN). Appendix B illustrates the financial statements of **Nestlé SA** (CHE), and Appendix C includes the financial statements of **Delfi Limited** (SGP). We refer to these statements at various places throughout the text. (In addition, in the *A Look at U.S. GAAP* section at the end of each chapter, the U.S. company **Apple Inc.** is analyzed.)

At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function.

- Bookkeeping usually involves **only** the recording of economic events.
- It is therefore just one part of the accounting process.

In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**[2]

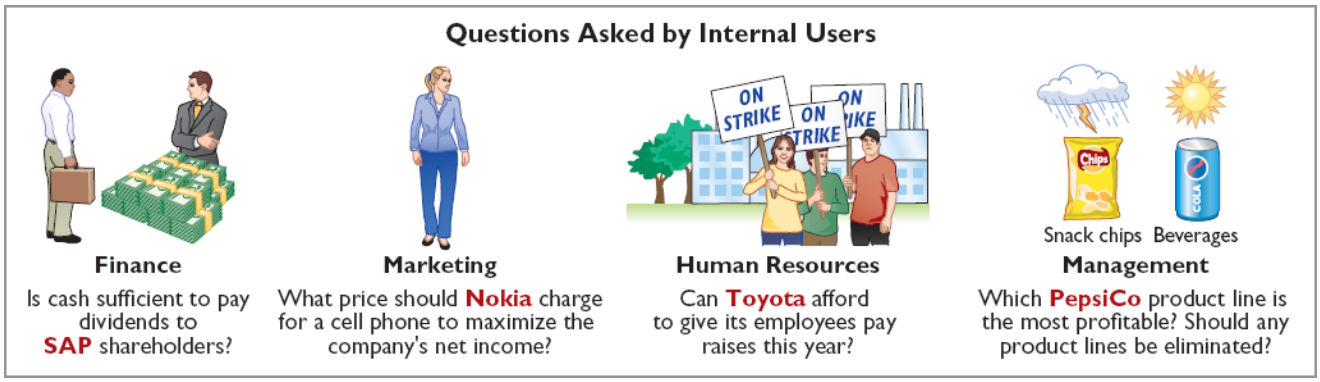
Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1.2.

ILLUSTRATION 1.2 Questions that internal users ask



To answer these and other questions, internal users need detailed information on a timely basis. Managerial accounting provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

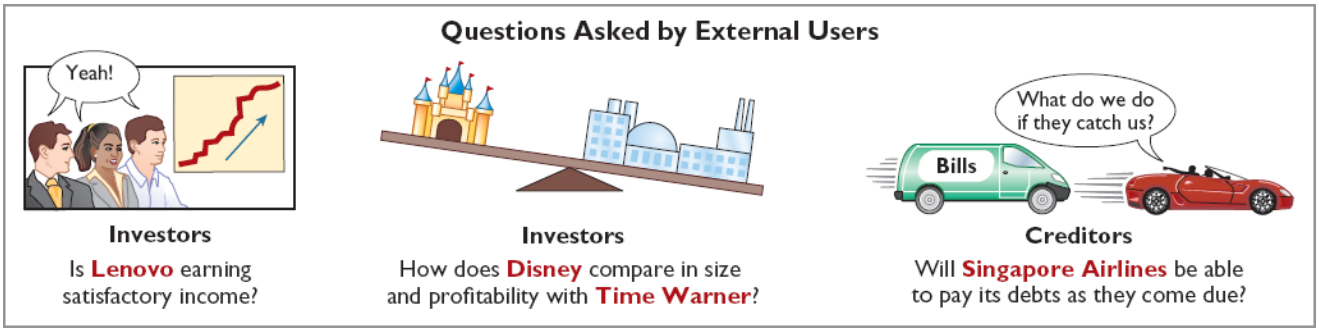
External Users

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

- **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company.
- **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.

Illustration 1.3 shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 Questions that external users ask



Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably.

- **Taxing authorities**, such as the **State Administration of Taxation in the People's Republic of China** (CHN), want to know whether the company complies with tax laws.
- **Regulatory agencies**, such as the **Financial Services Authority of Indonesia** (IDN), want to know whether the company is operating within prescribed rules.
- **Customers** are interested in whether a company like **Tesla Motors, Inc.** (USA) will continue to honor product warranties and support its product lines.
- **Labor unions**, such as the **Indian National Trade Union Congress** (IND), want to know whether companies have the ability to pay increased wages and benefits to union members.

Data Analytics

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

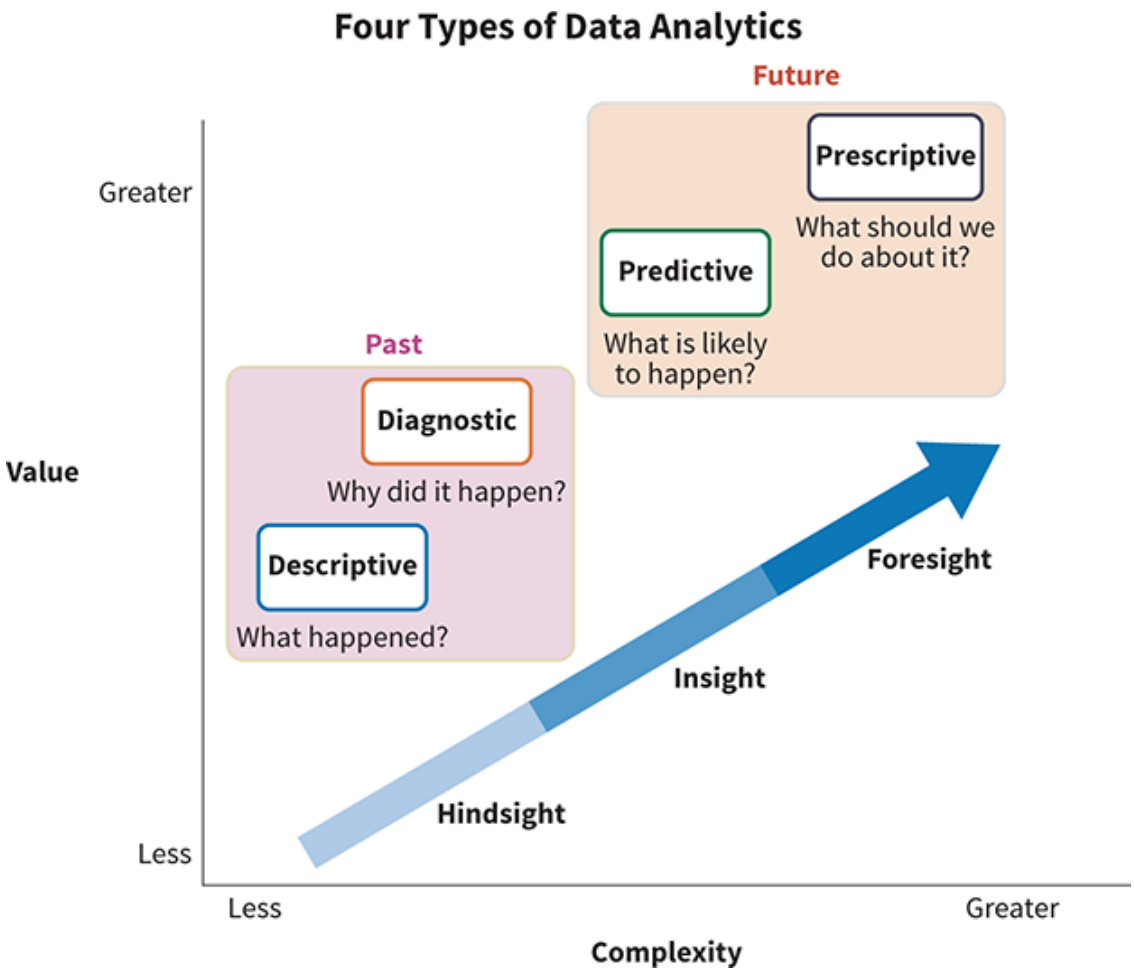
- Data analytics involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see Helpful Hint).

***Helpful Hints** further clarify concepts being discussed.*

> **HELPFUL HINT**
>
> **Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.**

Illustration 1.4 shows the four most common types of data analytics that help answer questions ranging from what happened and why did it happen, to what is likely to happen and what should we do about it? Analytics range from simple analysis that can be performed using spreadsheets with tools like pivot tables and graphs, to complex statistical software and even artificial intelligence. More complex analysis provides greater value to the business.

ILLUSTRATION 1.4 Four types of data analytics



Insight *boxes provide examples of business situations from various perspectives—ethics; investor, global; environmental, social, and governance; and data analytics.*

Data Analytics Insight

Netflix

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And **Netflix** (USA), the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.



UnSplash

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

> **Source:** Based on Ritwik Kumar et al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making?

Answer

*The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the **Action Plan** necessary to complete the exercise, and they show a **Solution**.*

DO IT! 1

Basic Concepts

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

ACTION PLAN

- **Review the basic concepts discussed.**
- **Develop an understanding of the key terms used.**

Solution

Related exercise material: **DO IT! 1.1**, **E1.1**, **and E1.2**.

1.2 The Building Blocks of Accounting

> **LEARNING OBJECTIVE 2**
>
> Explain the building blocks of accounting: ethics, principles, and assumptions.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't invest in the securities market if they think share prices are rigged. In recent years, the financial press has been full of articles about financial scandals at **Mahindra Satyam** (IND), **Toshiba** (JPN), **Pou Sheng International** (HKG), **Siwei** (CHN), and other companies.

As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent share prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this text:

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *Environmental, Social, and Governance Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in **Illustration 1.5**.

ILLUSTRATION 1.5 Steps in analyzing ethics cases and situations



1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Ethics Insight

Toshiba

Loyalty to Your Employer Is Great, Until It Is Not



nmann77/Adobe Stock

A common attribute of Japanese employees is a culture of strong loyalty to their employer. This loyalty arises out of a common practice of lifetime employment combined with a general cultural value of respect. While strong loyalty is a positive in many respects, it can create challenges in some circumstances.

For example, **Toshiba** (JPN), like many Japanese businesses, was severely affected by a series of events in the early 2000s. First, the company, along with the rest of the world, experienced the financial crisis and subsequent global recession in 2008 and 2009. Next, in 2011, an earthquake and subsequent tsunami in northern Japan triggered a significant recession in Japan. The company experienced a 14% decline in revenue from 2007 to 2013, and a 90% decline in profits over the same period.

In response to these events, company leadership began to pressure divisional and mid-level managers to achieve unreasonable financial goals. These managers, unable to meet the unreasonably high performance expectations and influenced by a strong culture of loyalty and respect, were left with little choice but to create profits where there were none. They committed a number of financial frauds, including unreasonable estimates and improper recording of transactions with suppliers.

In 2015, when these matters came to light, it was determined that reported revenues during this period had been overstated by ¥129 million and profits for the period has been overstated by ¥477 million.

Source: Based on Dennis Caplan, Saurav Dutta, and David Marchinko, "Unmasking the Fraud at Toshiba," *Issues in Accounting Education*, Vol. 34, No. 3 (August 2019).

What would you do if your company asked you to misreport an item?

Answer

Accounting Standards

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies. Presently, there are two primary accounting standard-setting bodies—the **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**.

- More than 150 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**.
- IFRSs are determined by the IASB. The IASB is headquartered in London, with its board members drawn from around the world.
- Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP)**.

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. We provide at the end of each chapter a section called *A Look at U.S. GAAP*, to provide a comparison with IFRS.

Global Insight

The Korean Discount



Toru-Hanai/Pool/
Getty Images

If you think that accounting standards don't matter, consider these events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Based on Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth?

Answer

Measurement Principles

IFRS uses one of two measurement bases, the historical cost basis or the current value basis. Selection of which basis to use is generally determined by considering the qualitative characteristics of useful information, including relevance and faithful representation (see Helpful Hint). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

HELPFUL HINT

***Relevance* and *faithful representation* are two primary qualities that make accounting information useful for decision-making.**

Historical Cost

The **historical cost basis** records and reports assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if Great Wall Manufacturing purchases land for ¥300,000 (amounts in thousands), the company initially reports it in its accounting records at ¥300,000. But what does Great Wall do if, by the end of the next year, the current value of the land has increased to ¥400,000? Under the historical cost basis, it continues to report the land at ¥300,000.

Current Value

The **current value basis** records and reports assets and other accounts at current value. Depending on the nature of the item being reported, current value is determined based on the item's fair value (the price received to sell an asset or settle a liability), value in use (the present value of the future cash flows associated with the item), or current cost (the current replacement cost of the item).

Current value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at current value because market value information is usually readily available for these types of assets.

- In determining which measurement basis to use, companies weigh the factual nature of historical cost figures versus the relevance of current value.
- In general, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to current value, most companies choose to use cost.

Only in situations where assets are actively traded, such as investment securities, do companies apply the current value extensively.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to using the historical cost basis.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money. Throughout this text, we use a variety of currencies in our examples and end-of-chapter materials, such as the following.

Australia, dollar	$	Russia, ruble	P
Brazil, real	R$	South Africa, rand	R
China, yuan renminbi	¥	South Korea, won	₩
Europe, euro	€	Switzerland, Swiss franc	CHF
Hong Kong, dollar	HK$	Taiwan, new dollar	NT$
India, rupee	₹	Turkey, lira	₺
Indonesia, rupia	Rp	United Kingdom, pound	£
Japan, yen	¥	United States, dollar	$

Economic Entity Assumption

An economic entity can be any organization or unit in society. It may be a company (such as **Maruti Suzuki** (IND)), a governmental unit (the Indonesian province of Papua), a municipality (Beijing), or a temple (the Temple of the Six Banyan Trees). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Barb Su, owner of Barb's Bike Shop, must keep her personal living costs separate from the expenses of the business. Similarly, **Maxway Cycles Co.** (TWN) and **Asia Bicycle Trading Company** (TWN) are segregated into separate economic entities for accounting purposes (see **Ethics Note**).

> **ETHICS NOTE**
>
> **The importance of the economic entity assumption is illustrated by scandals involving Adelphia (USA). In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over $2 billion of loans to the founding family.**

Ethics Notes *help sensitize you to some of the ethical issues in accounting.*

Proprietorship

A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships.

- Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship.

- The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.

There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership

A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved.

- Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner.
- Each partner generally has unlimited personal liability for the debts of the partnership.
- Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.

Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and accountants).

Corporation

A business organized as a separate legal entity under jurisdiction corporation law and having ownership divided into transferable shares is a **corporation**.

- The holders of the shares (shareholders) enjoy limited liability; that is, they are not personally liable for the debts of the corporate entity.
- Shareholders may transfer all or part of their ownership shares to other investors at any time (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation.
- Because ownership can be transferred without dissolving the corporation, the corporation enjoys an unlimited life.

Although the combined number of proprietorships and partnerships in the world significantly exceeds the number of corporations, the revenue produced by corporations is much greater. Most of the largest companies in the world—for example, **ING** (NLD), **Royal Dutch Shell** (GBR and NLD), **Apple Inc.** (USA), **Fortis** (BEL), and **Toyota** (JPN)—are corporations.

Accounting Across the Organization

Spinning the Career Wheel



blublaf/E+/Getty Images

One question that students frequently ask is, "How will the study of accounting help me?" A working knowledge of accounting is desirable for virtually *every field* of endeavor. Some examples of how accounting is used in other careers include the following.

General management: Imagine running **Volkswagen** (DEU), **Saudi Telecom** (SAU), a **Subway** (USA) franchise, or a **Fuji** (JPN) bike shop. All general managers need to understand where the company's cash comes from and where it goes in order to make wise business decisions.

Marketing: Marketing specialists at a company like **Hyundai Motor** (KOR) develop strategies to help the sales force be successful. But making a sale is meaningless unless it is profitable. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for **Shanghai Commercial and Savings Bank** (TWN) or a financial analyst for **ICBC** (CHN)? These fields rely heavily on accounting. In all of them, you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for **Hong Kong Property Services** (HKG)? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

How might accounting help you?

Answer

DO IT! 2

Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Ethics are the standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).
3. An asset recorded using the historical cost basis results in recording assets at their cost. In later periods, however, the current value of the asset must be used if current value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

ACTION PLAN

- **Review the discussion of ethics and financial reporting standards.**
- **Develop an understanding of the key terms used.**

Solution

Related exercise material: **DO IT! 1.2**, **E1.3**, **and E1.4**.

1.3 The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes.

- **Assets** are the resources a business owns. For example, **adidas** (DEU) has total assets of approximately €15,176 billion. Liabilities and equity are the rights or claims against these resources. Thus, adidas has €15,176 billion of claims against its €15,176 billion of assets.
- Claims of those to whom the company owes money (creditors) are called **liabilities**.
- Claims of owners are called **equity**. adidas has liabilities of €8,721 billion and equity of €6,455 billion.

We can express the relationship of assets, liabilities, and equity as an equation, as shown in **Illustration 1.6**.

ILLUSTRATION 1.6 The basic accounting equation

Assets	=	Liabilities	+	Equity

This relationship is the **basic accounting equation**.

- Assets must equal the sum of liabilities and equity.
- Liabilities appear before equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as adidas. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted previously, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales.

- The common characteristic possessed by all assets is **the capacity to provide future services or benefits**.
- In a business, that service potential or future economic benefit eventually results in cash inflows (receipts).

For example, consider Taipei Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Taipei Pizza are tables, chairs, sound system, cash register, oven, tableware, and, of course, cash.

Liabilities

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Taipei Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Taipei Pizza also has a **note payable** to First Bank for the money borrowed to purchase the delivery truck.
- Taipei Pizza may also have **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Taipei Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

Equity

The ownership claim on a company's total assets is **equity**. It is equal to total assets minus total liabilities. Here is why.

- The assets of a business are claimed by either creditors or shareholders. To find out what belongs to shareholders, we subtract creditors' claims (the liabilities) from the assets.
- The remainder is the shareholders' claim on the assets—equity. It is often referred to as **residual equity**—that is, the equity "left over" after creditors' claims are satisfied.

Equity generally consists of (1) share capital—ordinary and (2) retained earnings.

Share Capital—Ordinary

A company may obtain funds by selling ordinary shares to investors. **Share capital—ordinary** is the term used to describe the amounts paid in by shareholders for the ordinary shares they purchase.

Retained Earnings

Retained earnings is determined by three items: revenues, expenses, and dividends.

Revenues

Revenues are the gross increases in equity resulting from business activities entered into for the purpose of earning income (see **Helpful Hint**).[3] Generally, revenues result from selling merchandise, performing services, renting property, and lending money.

> **HELPFUL HINT**
>
> **The effect of revenues is positive—an increase in equity coupled with an increase in assets or a decrease in liabilities.**

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Taipai Pizza, for instance, has two categories of sales

revenues—pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are sales, fees, services, commissions, interest, dividends, royalties, and rent.

Expenses

Expenses are the cost of assets consumed or services used in the process of earning revenue. **They are decreases in equity that result from operating the business** (see **Helpful Hint**). Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used.

> **HELPFUL HINT**
>
> **The effect of expenses is negative—a decrease in equity coupled with a decrease in assets or an increase in liabilities.**

For example, Taipai Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.), cost of beverages, wages expense, utilities expense (electric, gas, and water expense), telephone expense, delivery expense (gasoline, repairs, licenses, etc.), supplies expense (napkins, detergents, aprons, etc.), rent expense, interest expense, and property tax expense.

Dividends

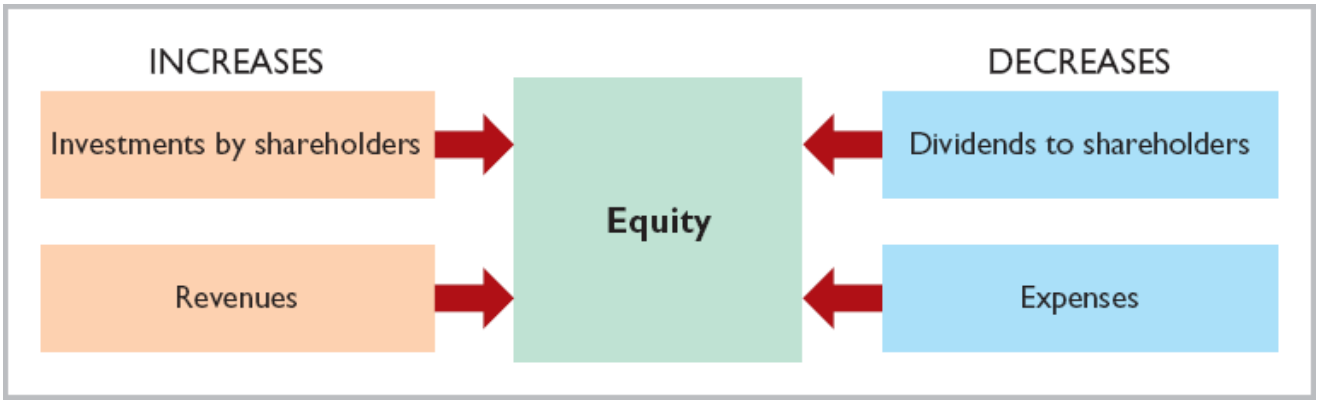
Net income represents an increase in net assets which is then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a **dividend**.

- Dividends reduce retained earnings.
- However, dividends are **not expenses**.

A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the shareholders).

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast, reductions (decreases) in equity result from expenses and dividends. These relationships are shown in **Illustration 1.7**.

ILLUSTRATION 1.7 Increases and decreases in equity



DO IT! 3

Equity Effects

Classify the following items as issuance of shares (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

a. Rent Expense.

b. Service Revenue.

c. Dividends.

d. Salaries and Wages Expense.

ACTION PLAN

- **Understand the sources of revenue.**
- **Understand what causes expenses.**
- **Review the rules for changes in equity: Investments and revenues increase equity. Expenses and dividends decrease equity.**
- **Recognize that dividends are distributions of cash or other assets to shareholders.**

Solution

Related exercise material: **BE1.1**, **BE1.2**, **BE1.3**, **BE1.4**, **BE1.5**, **BE1.6**, **DO IT! 1.3**, **and E1.5**.

1.4 Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.



This accounting cycle graphic illustrates the steps companies follow each period to record transactions and eventually prepare financial statements.

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

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. Many companies upgraded their accounting information systems to prevent cybersecurity attacks. In addition, companies are utilizing new technologies.

- Cloud-based storage permits employees to access records from different locations.
- Data automation and analytics tools help companies interpret large volumes of data to support enhanced decision-making and automating routine processes.

In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** (USA) stated, "We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area."

Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic, the accounting cycle begins with the analysis of business transactions and ends with the

preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters 2–4.

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

Accounting Transactions

Transactions (**business transactions**) are a business's economic events recorded by accountants. Transactions may be external or internal.

- **External transactions** involve economic events between the company and some outside enterprise. For example, Taipai Pizza's purchase of cooking equipment from a supplier, payment of monthly rent to the landlord, and sale of pizzas to customers are external transactions.
- **Internal transactions** are economic events that occur entirely within one company. The use of cooking and cleaning supplies are internal transactions for Taipai Pizza.

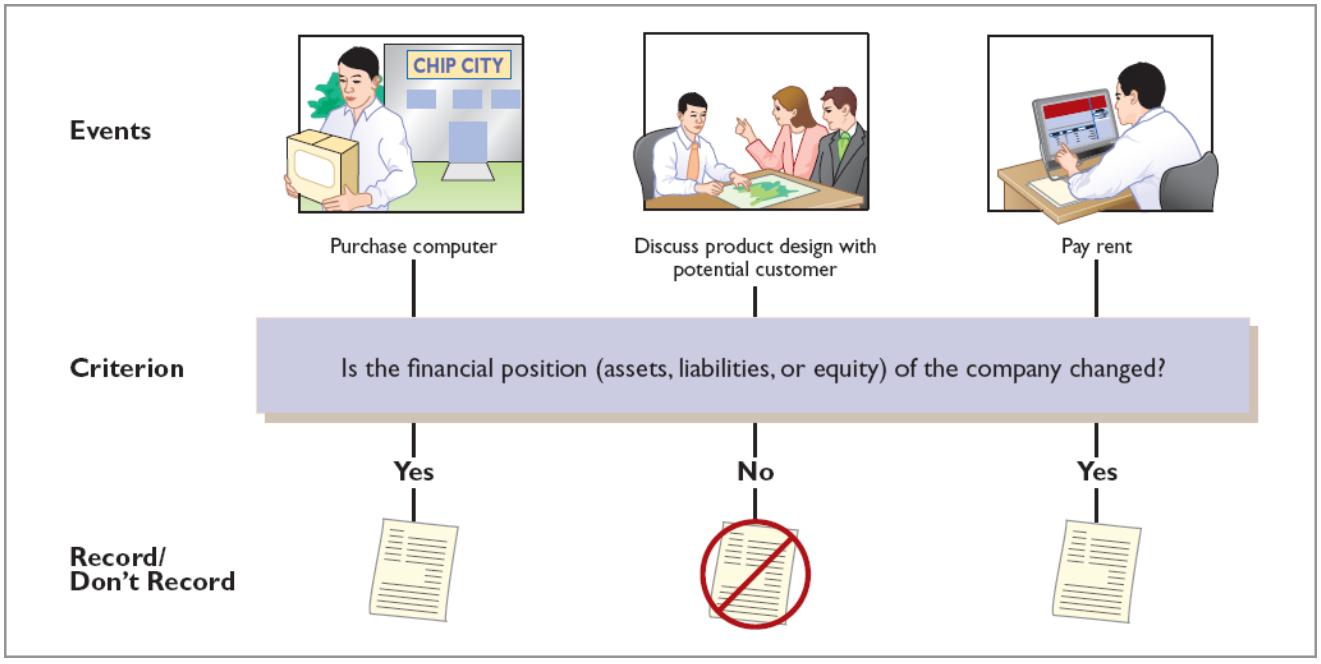
Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions. Employees will earn wages, and suppliers will deliver ordered merchandise.

A company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. **Illustration 1.8** demonstrates the transaction identification process.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding:

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

ILLUSTRATION 1.8 Transaction identification process



Two or more items could be affected. For example, as one asset is increased €10,000, another asset could decrease €6,000 and a liability could increase €4,000. Any change in a liability or ownership claim is subject to similar analysis.

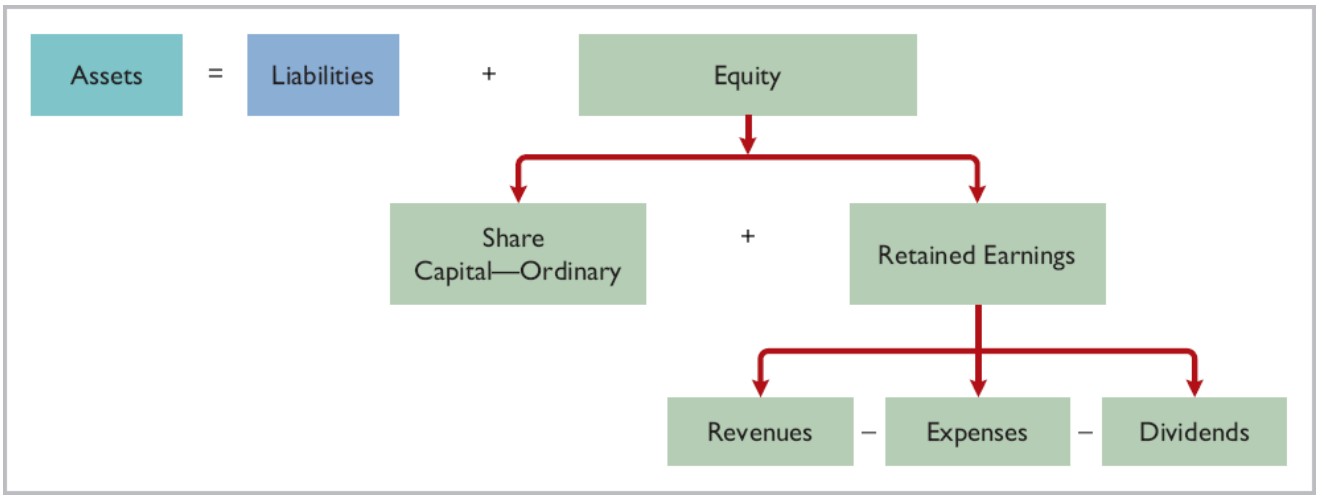
Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte SA. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on equity. Recall that equity is comprised of two parts: share capital—ordinary and retained earnings.

- Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash.
- Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends.

Illustration 1.9 shows the expanded accounting equation.

ILLUSTRATION 1.9 Expanded accounting equation



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

> **HELPFUL HINT**
>
> **You will want to study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.**

Transaction (1). Investment by Shareholders

Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2025, they invest €15,000 cash in the business in exchange for €15,000 of ordinary shares. The ordinary shares indicates the ownership interest that the Neals have in Softbyte SA. This transaction results in an equal increase in both assets and equity.[4]

Basic Analysis	The asset Cash increases €15,000, and equity identified as Share Capital—Ordinary increases €15,000.

Equation Analysis

	Assets	=	Liabilities	+	Equity	
	Cash	=			Share Capital	
(1)	+€15,000	=			+€15,000	Issued Shares

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, issued shares) is indicated. Why does this matter?

- Because investments by shareholders do not represent revenues, and they are excluded in determining net income.
- Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations.

Additional investments (i.e., investments made by shareholders after the corporation has been initially formed) have the same effect on equity as the initial investment.

Transaction (2). Purchase of Equipment for Cash

Softbyte SA purchases computer equipment for €7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

Basic Analysis

The asset Cash decreases €7,000, and the asset Equipment increases €7,000.

Equation Analysis

	Assets			=	Liabilities	+	Equity
	Cash	+	Equipment	=			Share Capital
	€15,000						€15,000
(2)	−7,000		+€7,000				
	€ 8,000	+	€7,000	=			€15,000
	€15,000						

Observe that total assets are still €15,000. Share Capital—Ordinary also remains at €15,000, the amount of the original investment.

Transaction (3). Purchase of Supplies on Credit

Softbyte SA purchases headsets (and other computer accessories expected to last several months) for €1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October.

- This transaction is a purchase on account (a credit purchase).
- Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions.

Basic Analysis

The asset Supplies increases €1,600, and the liability Accounts Payable increases €1,600.

Equation Analysis

	Assets					=	Liabilities	+	Equity
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital
	€8,000				€7,000				€15,000
(3)			+€1,600				+€1,600		
	€8,000	+	€1,600	+	€7,000	=	€1,600	+	€15,000
			€16,600						€16,600

Total assets are now €16,600. This total is matched by a €1,600 creditor's claim and a €15,000 ownership claim.

Transaction (4). Services Performed for Cash

Softbyte SA receives €1,200 cash from customers for app development services it has performed. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases equity**.

Basic Analysis

The asset Cash increases €1,200, and equity increases €1,200 due to Service Revenue.

Equation Analysis

	Assets					=	Liabilities	+	Equity				
										Retained Earnings			
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+ Rev.	− Exp.	− Div.	
	€8,000		€1,600		€7,000		€1,600		€15,000				
(4)	+1,200									+€1,200			Service Revenue
	€9,200	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+ €1,200			
			€17,800						€17,800				

The two sides of the equation balance at €17,800. Service Revenue is included in determining Softbyte's net income.

- Note that we do not have room to give details for each individual revenue and expense account in this illustration. Thus, revenues (and expenses when we get to them) are summarized under one column heading for Revenues and one for Expenses.
- However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements later in the chapter.

Transaction (5). Purchase of Advertising on Credit

Softbyte SA receives a bill for €250 from *Programming News* for advertising on its website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in equity.

Basic Analysis

The liability Accounts Payable increases €250, and equity decreases €250 due to Advertising Expense.

Equation Analysis

	Assets				=	Liabilities	+	Equity				
						Accounts		Share	Retained Earnings			
	Cash	+ Supplies	+ Equipment		=	Payable	+	Capital	+ Rev.	− Exp.	− Div.	
	€9,200	€1,600	€7,000			€1,600		€15,000	€1,200			
(5)						+250				−€250		Advertising Expense
	€9,200	+ €1,600	+ €7,000	= €17,800		€1,850	+	€15,000	+ €1,200	− €250	= €17,800	

The two sides of the equation still balance at €17,800. Retained Earnings decreases when Softbyte incurs the expense.

- Expenses do not have to be paid in cash at the time they are incurred.
- When Softbyte pays at a later date, the liability Accounts Payable will decrease and the asset Cash will decrease [see Transaction (8)].

The cost of advertising is an expense (rather than an asset) because Softbyte has used the benefits. Advertising Expense is included in determining net income.

Transaction (6). Services Performed for Cash and Credit

Softbyte SA performs €3,500 of app development services for customers. The company receives cash of €1,500 from customers, and it bills the balance of €2,000 on account. This transaction results in an equal increase in assets and equity.

Basic Analysis

Three specific items are affected: The asset Cash increases €1,500, the asset Accounts Receivable increases €2,000, and equity increases €3,500 due to Service Revenue.

Equation Analysis

	Assets				=	Liabilities	+	Equity				
		Accounts				Accounts		Share	Retained Earnings			
	Cash	+ Receivable	+ Supplies	+ Equipment	=	Payable	+	Capital	+ Rev.	− Exp.	− Div.	
	€ 9,200		€1,600	€7,000		€1,850		€15,000	€1,200	€250		
(6)	+1,500	+€2,000							+3,500			Service Revenue
	€10,700	+ €2,000	+ €1,600	+ €7,000	=	€1,850	+	€15,000	+ €4,700	− €250		
			€21,300					€21,300				

Softbyte recognizes €3,500 in revenue when it performs the services. In exchange for these services, it received €1,500 in Cash and Accounts Receivable of €2,000. This Accounts Receivable represents customers' promise to pay €2,000 to Softbyte in the future. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

Transaction (7). Payment of Expenses

Softbyte SA pays the following expenses in cash for September: office rent €600, salaries and wages of employees €900, and utilities €200. These payments result in an equal decrease in assets and equity.

Basic Analysis

The asset Cash decreases €1,700, and equity decreases €1,700 due to the following specific expenses: Rent Expense, Salaries and Wages Expense, and Utilities Expense.

Equation Analysis

	Assets				= Liabilities	+ Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings: Rev.	− Exp.	− Div.	
	€10,700	€2,000	€1,600	€7,000	€1,850	€15,000	€4,700	€ 250		
(7)	−1,700							−600		Rent Exp.
								−900		Sal./Wages Exp.
								−200		Utilities Exp.
	€ 9,000	+ €2,000	+ €1,600	+ €7,000	= €1,850	+ €15,000	+ €4,700	− €1,950		
	€19,600				€19,600					

The two sides of the equation now balance at €19,600. Three lines are required in the analysis to indicate the different types of expenses that have been incurred.

Transaction (8). Payment of Accounts Payable

Softbyte SA pays its €250 *Programming News* bill in cash. The company previously [in Transaction (5)] recorded the bill as an increase in Accounts Payable and a decrease in equity.

Basic Analysis

This cash payment "on account" decreases the asset Cash by €250 and also decreases the liability Accounts Payable by €250.

Equation Analysis

	Assets				= Liabilities	+ Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings: Rev.	− Exp.	− Div.	
	€9,000	€2,000	€1,600	€7,000	€1,850	€15,000	€4,700	€1,950		
(8)	−250				−250					
	€8,750	+ €2,000	+ €1,600	+ €7,000	= €1,600	+ €15,000	+ €4,700	− €1,950		
	€19,350				€19,350					

Observe that the payment of a liability related to an expense that has previously been recorded does not affect equity. Softbyte recorded the expense [in Transaction (5)] and should not record it again.

Transaction (9). Receipt of Cash on Account

Softbyte SA receives €600 in cash from customers who had been billed for services [in Transaction (6)]. Transaction (9) does not change total assets, but it changes the composition of those assets.

Basic Analysis

The asset Cash increases €600, and the asset Accounts Receivable decreases €600.

Equation Analysis

	Assets				= Liabilities	+ Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings: Rev.	− Exp.	− Div.	
	€8,750	€2,000	€1,600	€7,000	€1,600	€15,000	€4,700	€1,950		
(9)	+600	−600								
	€9,350	+ €1,400	+ €1,600	+ €7,000	= €1,600	+ €15,000	+ €4,700	− €1,950		
	€19,350				€19,350					

Note that the collection of an account receivable for services previously billed and recorded does not affect equity. Softbyte already recorded this revenue [in Transaction (6)] and should not record it again.

Transaction (10). Dividends

The company pays a dividend of €1,300 in cash to Ray and Barbara Neal, the shareholders of Softbyte SA. This transaction results in an equal decrease in assets and equity.

Basic Analysis	The asset Cash decreases €1,300, and equity decreases €1,300 due to dividends.

Equation Analysis

	Assets				= Liabilities	+ Equity				
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings Rev.	− Exp.	− Div.	
	€9,350	€1,400	€1,600	€7,000	€1,600	€15,000	€4,700	€1,950		
(10)	−1,300								−€1,300	Dividends
	€8,050	+ €1,400	+ €1,600	+ €7,000	= €1,600	+ €15,000	+ €4,700	− €1,950	− €1,300	
	€18,050				€18,050					

Note that the dividend reduces retained earnings, which is part of equity. **Dividends are not expenses**. Like shareholders' investments, dividends are excluded in determining net income.

Summary of Transactions

Illustration 1.10 summarizes the September transactions of Softbyte SA to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction. Finally, Illustration 1.10 demonstrates a number of significant facts:

1. Each transaction must be analyzed in terms of its effect on:
   a. The three components of the basic accounting equation.
   b. Specific types (kinds) of items within each component.
2. The two sides of the equation must always be equal.
3. The Share Capital—Ordinary and Retained Earnings columns indicate the causes of each change in the shareholders' claim on assets.

ILLUSTRATION 1.10 Tabular summary of Softbyte SA transactions

	Assets				= Liabilities	+ Equity				
Trans-action	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Retained Earnings Rev.	− Exp.	− Div.	
(1)	+€15,000					+ €15,000				Issued Shares
(2)	−7,000			+€7,000						
(3)			+€1,600		+€1,600					
(4)	+1,200						+€1,200			Service Revenue
(5)					+250			−€250		Adver. Expense
(6)	+1,500	+€2,000					+3,500			Service Revenue
(7)	−1,700							−600		Rent Expense
								−900		Sal./Wages Exp.
								−200		Utilities Expense
(8)	−250				−250					
(9)	+600	−600								
(10)	−1,300								−€1,300	Dividends
	€ 8,050	+ €1,400	+ €1,600	+ €7,000	= €1,600	+ €15,000	+ €4,700	− €1,950	− €1,300	
	€18,050				€18,050					

There! You made it through transaction analysis. If you feel a bit shaky on any of the transactions, it might be a good idea at this point to get up, take a short break, and come back again for a brief (10- to 15-minute) review of the transactions, to make sure you understand them before you go on to the next section.

DO IT! 4

Tabular Analysis

Transactions made by Virmari & Co., a public accounting firm in France, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1.10.

1. The company issued ordinary shares for €25,000 cash.
2. The company purchased €7,000 of office equipment on credit.
3. The company received €8,000 cash in exchange for services performed.
4. The company paid €850 for this month's rent.
5. The company paid a dividend of €1,000 in cash to shareholders.

ACTION PLAN

- **Analyze the effects of each transaction on the accounting equation.**
- **Use appropriate category names (not descriptions).**
- **Keep the accounting equation in balance.**

Solution

Related exercise material: **BE1.7**, **BE1.8**, **BE1.9**, **DO IT! 1.4**, **E1.6**, **E1.7**, **and E1.8**.

1.5 Financial Statements

LEARNING OBJECTIVE 5

Describe the five financial statements and how they are prepared.

Companies prepare five financial statements from the summarized accounting data (see **Helpful Hint**):

1. An **income statement** presents the revenues and expenses and resulting net income or net loss for a specific period of time.
2. A **retained earnings statement** summarizes the changes in retained earnings for a specific period of time.[5]
3. A **statement of financial position** (sometimes referred to as a *balance sheet*) reports the assets, liabilities, and equity of a company at a specific date.
4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
5. A **comprehensive income statement** presents other comprehensive income items that are not included in the determination of net income. Note that IFRS contains two concepts of income: net income and comprehensive income. In later chapters, we will provide more insight into the differences between these two income concepts.

HELPFUL HINT

The income statement, retained earnings statement, statement of cash flows, and comprehensive income statement are all for a *period* of time, whereas the statement of financial position is for a *point* in time.

These statements provide relevant financial data for internal and external users. **Illustration 1.11** shows the first four financial statements from the above list of Softbyte SA (see **Helpful Hints**). (Illustration 1.11 assumes Softbyte has no other comprehensive income items.) A comprehensive income statement is presented in Illustration 1.13 for Softbyte.

Note that the statements shown in Illustration 1.11 are interrelated:

1. Net income of €2,750 on the **income statement** is added to the beginning balance of retained earnings in the **retained earnings statement**.
2. Retained earnings of €1,450 at the end of the reporting period shown in the **retained earnings statement** is reported on the **statement of financial position**.
3. Cash of €8,050 on the **statement of financial position** is reported on the **statement of cash flows**.

Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate these notes and schedules in later chapters of this text.

Be sure to carefully examine the format and content of each statement in Illustration 1.11. We describe the essential features of each in the following sections.

HELPFUL HINT

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

HELPFUL HINT

The arrows in this illustration show the interrelationships of the four financial statements.

1. **Net income is computed first and is needed to determine the ending balance in retained earnings.**
2. **The ending balance in retained earnings is needed in preparing the statement of financial position.**
3. **The cash shown on the statement of financial position is needed in preparing the statement of cash flows.**

HELPFUL HINT

Note that final sums are double-underlined, and negative amounts (in the statement of cash flows) are presented in parentheses.

ILLUSTRATION 1.11 **Financial statements and their interrelationships**

Softbyte SA
Income Statement
For the Month Ended September 30, 2025

Revenues		
Service revenue		€4,700
Expenses		
Salaries and wages expense	€900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		**€2,750**

Softbyte SA
Retained Earnings Statement
For the Month Ended September 30, 2025

Retained earnings, September 1		€ 0
Add: Net income		**2,750**
		2,750
Less: Dividends		1,300
Retained earnings, September 30		**€1,450**

Softbyte SA
Statement of Financial Position
September 30, 2025

Assets		
Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		**8,050**
Total assets		€18,050
Equity and Liabilities		
Equity		
Share capital—ordinary	€15,000	
Retained earnings	**1,450**	€16,450
Liabilities		
Accounts payable		1,600
Total equity and liabilities		€18,050

Softbyte SA
Statement of Cash Flows
For the Month Ended September 30, 2025

Cash flows from operating activities		
Cash receipts from revenues		€ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of ordinary shares	€15,000	
Payment of cash dividends	(1,300)	13,700
Net increase in cash		8,050

1

2

3

Net increase in cash	8,050
Cash at the beginning of the period	0
Cash at the end of the period	€ 8,050

Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time. For example, Softbyte SA's income statement is dated "For the Month Ended September 30, 2025." It is prepared from the data appearing in the revenue and expense columns of Illustration 1.10. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

- The income statement lists revenues first, followed by expenses.
- Then, the statement shows net income (or net loss).
- When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

Although practice varies, we have chosen to list expenses in order of magnitude in our illustrations. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the shareholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte SA was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in equity.

Retained Earnings Statement

Softbyte SA's retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2025"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1.10) and from the income statement (Illustration 1.11).

- The first line of the statement shows the beginning retained earnings amount, followed by net income and dividends.
- The retained earnings ending balance is the final amount on the statement.
- The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

Statement of Financial Position

Softbyte SA's statement of financial position reports the assets, liabilities, and equity at a specific date (September 30, 2025). The company prepares the statement of financial position from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1.10).

- Observe that the statement of financial position lists assets at the top, followed by equity and then liabilities.
- Total assets must equal total equity and liabilities.

Softbyte SA reports only one liability, Accounts Payable, on its statement of financial position. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in **Illustration 1.12**.

ILLUSTRATION 1.12 Presentation of liabilities

Liabilities	
Notes payable	€10,000
Accounts payable	63,000
Salaries and wages payable	18,000
Total liabilities	**€91,000**

The statement of financial position is like a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

Accounting Across the Organization

Vodafone

A Wise End



Chris Ison/AP Photos

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are **Vodafone Group** (GBR), March 31; **Walt Disney Company** (USA), the Saturday closest to September 30; and **Diageo** (GBR), June 30. Why do companies choose the particular year-ends that they do?

Many companies opt to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.

What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends?

Answer

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing activities, (3) its financing activities, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period (see Helpful Hint).

> **HELPFUL HINT**
>
> **Investing activities pertain to investments made by the company, not investments made by the owners.**

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

As shown in Softbyte SA's statement of cash flows in Illustration 1.11, cash increased €8,050 during the period. Net cash provided by operating activities increased cash €1,350. Cash flow from investing activities decreased cash €7,000. And cash flow from financing activities increased cash €13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 13 will examine in detail how the statement is prepared.

Comprehensive Income Statement

In some cases, Softbyte SA must prepare a comprehensive income statement in addition to its income statement. Softbyte prepares this second statement if it has other comprehensive income items.

- Other comprehensive income items are not part of net income but are considered important enough to be reported separately.
- Softbyte adds other comprehensive income to net income to arrive at comprehensive income.

Illustration 1.13 shows a comprehensive income statement, assuming that Softbyte SA has other comprehensive income of €600.

ILLUSTRATION 1.13 Comprehensive income statement

Softbyte SA Comprehensive Income Statement For the Month Ended September 30, 2025	
Net income	€2,750
Other comprehensive income	600
Comprehensive income	€3,350

In this two statement format, the comprehensive income statement is reported directly after the traditional income statement. Examples of this two statement format can be seen in the financial statements of **Nestlé** and **Delfi Limited** in Appendices B and C, respectively.

IFRS does allow an alternative statement format in which the information contained in the income statement and the comprehensive income statement are combined in a single statement, referred to as a **statement of comprehensive income**. An example of this approach can be seen in the financial statements of **TSMC** in Appendix A. *In this text, we use the two statement approach*. We provide a more detailed discussion about the components of other comprehensive income in later chapters.

Environmental, Social, and Governance Insight

Beyond Financial Statements



Marek Uliasz/
Getty Images

Should we expand our financial statements beyond the income statement, retained earnings statement, statement of financial position, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing shareholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But, many interesting and useful efforts are underway.

Throughout this text, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to shareholders.

Why might a company's shareholders be interested in its environmental and social performance?

Answer

DO IT! 5

Financial Statement Items

Presented below is selected information related to Li Fashions at December 31, 2025. Li reports financial information monthly.

Equipment	HK$10,000	Utilities Expense	HK$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

a. Determine the total assets of Li at December 31, 2025.

b. Determine the net income that Li reported for December 2025.

c. Determine the equity of Li at December 31, 2025.

ACTION PLAN

- **Remember the basic accounting equation: assets must equal liabilities plus equity.**
- **Review previous financial statements to determine how total assets, net income, and equity are computed.**

Solution

Related exercise material: **BE1.10**, **BE1.11**, **DO IT! 1.5**, **E1.9**, **E1.10**, **E1.11**, **E1.12**, **E1.13**, **E1.14**, **E1.15**, **E1.16**, **E1.17**, **and E1.18**.

Appendix 1A Career Opportunities in Accounting

LEARNING OBJECTIVE *6

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

- There are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."
- It is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the turmoil over toxic (misstated) assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
- Recent internal control requirements dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, an independent accountant such as a Chartered Accountant (CA) or a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position in accordance with international financial reporting

standards. Analysts, investors, and creditors rely heavily on these "audit opinions," which CAs and CPAs have the exclusive authority to issue.

Taxation is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies.

A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to performing support services for major marketing projects and merger and acquisition activities.

Many accountants are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Sinopec** (CHN), **Google** (USA), or **Samsung** (KOR). In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation. You might also be a member of your company's internal audit team. In response to increased internal control requirements, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on greater importance.

Alternatively, many accountants work for not-for-profit organizations such as the **International Red Cross** (CHE) or the **Bill and Melinda Gates Foundation** (USA), or for museums, libraries, or performing arts organizations.

Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, tax authorities, law enforcement agencies, and company regulators all employ accountants. There is also a very high demand for accounting educators at public colleges and universities and in local governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of theft and fraud occurring at companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

The Review and Practice section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Review and Practice

Learning Objectives Review

1 Identify the activities and users associated with accounting.

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labor unions.

2 Explain the building blocks of accounting: ethics, principles, and assumptions.

Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behavior.

Accounting is based on standards such as International Financial Reporting Standards (IFRS). IFRS generally uses one of two measurement principles. The monetary unit assumption requires that companies include in

the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

3 State the accounting equation, and define its components.

The basic accounting equation is:

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

Assets are resources a business owns. Liabilities are creditorship claims on total assets. Equity is the ownership claim on total assets.

The expanded accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Share Capital—Ordinary} + \text{Revenues} - \text{Expenses} - \text{Dividends}$$

Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash. Revenues are the gross increase in equity resulting from business activities for the purpose of earning income. Expenses are the costs of assets consumed or services used in the process of earning revenue. Dividends are payments the company makes to its shareholders.

4 Analyze the effects of business transactions on the accounting equation.

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in equity.

5 Describe the five financial statements and how they are prepared.

An income statement presents the revenues and expenses, and resulting net income or net loss, for a specific period of time. A retained earnings statement summarizes the changes in retained earnings for a specific period of time. A statement of financial position reports the assets, liabilities, and equity at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time. A comprehensive income statement adds or subtracts any items of other comprehensive income to net income to arrive at comprehensive income.

***6 Explain the career opportunities in accounting.**

Accounting offers many different jobs in fields such as public and private accounting, governmental, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

Glossary Review

Accounting
The information system that identifies, records, and communicates the economic events of an organization to interested users.

Accounting information system
The system of collecting and processing transaction data and communicating financial information to decision-makers.

Assets
Resources a business owns.

***Auditing**
The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation.

Basic accounting equation
Assets = Liabilities + Equity.

Bookkeeping
A part of the accounting process that involves only the recording of economic events.

Comprehensive income statement
A financial statement that presents items that are not included in the determination of net income, referred to as other comprehensive income.

Corporation
A business organized as a separate legal entity under jurisdiction corporation law, having ownership divided into transferable shares.

Current value basis
A measurement basis that results in reporting assets and liabilities at current value.

Data analytics
The evaluation of data, often employing both software and statistics, to draw inferences.

Dividend
A distribution of cash or other assets by a corporation to its shareholders.

Economic entity assumption
An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

Equity
The ownership claim on a company's total assets.

Ethics
The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.

Expanded accounting equation
Assets = Liabilities + Share Capital—Ordinary + Revenues − Expenses − Dividends.

Expenses
The cost of assets consumed or services used in the process of earning revenue.

Faithful representation
Numbers and descriptions match what really existed or happened—they are factual.

Financial accounting
The field of accounting that provides economic and financial information for investors, creditors, and other external users.

Financial Accounting Standards Board (FASB)
A private organization that establishes generally accepted accounting principles (GAAP) in the United States.

***Forensic accounting**
An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

Generally accepted accounting principles (GAAP)
Common U.S. standards that indicate how to report economic events.

Historical cost basis
A measurement basis that results in companies recording assets and other accounts at their cost.

Income statement
A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.

International Accounting Standards Board (IASB)
An accounting standard-setting body that issues standards adopted by many countries outside of the United States.

International Financial Reporting Standards (IFRS)
International accounting standards set by the International Accounting Standards Board (IASB).

Liabilities
Creditor claims on total assets.

***Management consulting**
An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities.

Managerial accounting
The field of accounting that provides internal reports to help users make decisions about their companies.

Monetary unit assumption

An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money.

Net income
The amount by which revenues exceed expenses.

Net loss
The amount by which expenses exceed revenues.

Partnership
A business owned by two or more persons associated as partners.

***Private (or managerial) accounting**
An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation.

Proprietorship
A business owned by one person.

***Public accounting**
An area of accounting in which the accountant offers expert service to the general public.

Relevance
Financial information that is capable of making a difference in a decision.

Retained earnings statement
A financial statement that summarizes the changes in retained earnings for a specific period of time.

Revenues
The gross increase in equity resulting from business activities entered into for the purpose of earning income.

Share capital—ordinary
Amounts paid in by shareholders for the ordinary shares they purchase.

Statement of cash flows
A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time.

Statement of financial position (balance sheet)
A financial statement that reports the assets, liabilities, and equity of a company at a specific date.

***Taxation**
An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies.

Transactions
The economic events of a business that are recorded by accountants.

Practice Multiple-Choice Questions

1. **(LO 1)** Which of the following is **not** a step in the accounting process?

   a. Identification.

   b. Economic entity.

   c. Recording.

   d. Communication.

Solution

2. **(LO 1)** Which of the following statements about users of accounting information is **incorrect**?

   a. Management is an internal user.

   b. Taxing authorities are external users.

   c. Present creditors are external users.

   d. Regulatory authorities are internal users.

Solution

3. **(LO 2)** The historical cost basis results in:

a. initially recording assets at cost and adjusting when the current value changes.

b. keeping activities of an entity separate and distinct from its owner.

c. recording and reporting assets at their cost.

d. including only transaction data capable of being expressed in terms of money in the accounting records.

Solution

4. (LO 2) Which of the following statements about basic assumptions is **correct**?

a. Basic assumptions are the same as accounting principles.

b. The economic entity assumption states that there should be a particular unit of accountability.

c. The monetary unit assumption enables accounting to measure employee morale.

d. Partnerships are not economic entities.

Solution

5. (LO 2) The three types of business entities are:

a. proprietorships, small businesses, and partnerships.

b. proprietorships, partnerships, and corporations.

c. proprietorships, partnerships, and large businesses.

d. financial, manufacturing, and service companies.

Solution

6. (LO 3) Net income will result during a time period when:

a. assets exceed liabilities.

b. assets exceed revenues.

c. expenses exceed revenues.

d. revenues exceed expenses.

Solution

7. (LO 3) As of December 31, 2025, Stoneland AG has assets of €3,500 and equity of €2,000. What are the liabilities for Stoneland AG as of December 31, 2025?

a. €1,500.

b. €1,000.

c. €2,500.

d. €2,000.

Solution

8. (LO 4) Performing services on account will have the following effects on the components of the basic accounting equation:

a. increase assets and decrease equity.

b. increase assets and increase equity.

c. increase assets and increase liabilities.

d. increase liabilities and increase equity.

Solution

9. (LO 4) Which of the following events is **not** recorded in the accounting records?

a. Equipment is purchased on account.

b. An employee is terminated.

c. A cash investment is made into the business.

d. The company pays a cash dividend.

Solution

10. (LO 4) During 2025, Xia Lin Company's assets decreased ¥500,000 and its liabilities decreased ¥900,000. Its equity therefore:

a. increased ¥400,000.

b. decreased ¥1,400,000.

c. decreased ¥400,000.

d. increased ¥1,400,000.

Solution

11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.

a. decreases equity and decreases liabilities.

b. increases assets and decreases liabilities.

c. decreases assets and increases equity.

d. decreases assets and decreases liabilities.

Solution

12. (LO 5) Which of the following statements is **false**?

a. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

b. A statement of financial position reports the assets, liabilities, and equity at a specific date.

c. An income statement presents the revenues, expenses, assets, and liabilities for a specific period of time.

d. A retained earnings statement summarizes the changes in retained earnings for a specific period of time.

Solution

13. (LO 5) On the last day of the period, Jim Otto Company buys a $900 machine on credit. This transaction will affect the:

a. income statement only.

b. statement of financial position only.

c. income statement and retained earnings statement only.

d. income statement, retained earnings statement, and statement of financial position.

Solution

14. (LO 5) The financial statement that reports assets, liabilities, and equity is the:

a. income statement.

b. retained earnings statement.

c. statement of financial position.

d. statement of cash flows.

Solution

***15. (LO 6)** Services performed by a public accountant include:

a. auditing, taxation, and management consulting.

b. auditing, budgeting, and management consulting.

c. auditing, budgeting, and cost accounting.

d. internal auditing, budgeting, and management consulting.

Solution

Practice Brief Exercises

Use basic accounting equation.

1. **(LO 3)** At the beginning of the year, Ortiz Eyewear had total assets of £900,000 and total liabilities of £440,000. Answer the following questions.

a. If total assets decreased £100,000 during the year and total liabilities increased £80,000 during the year, what is the amount of equity at the end of the year?

b. During the year, total liabilities decreased £100,000 and equity increased £200,000. What is the amount of total assets at the end of the year?

c. If total assets increased £50,000 during the year and equity increased £60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

Determine effect of transactions on basic accounting equation

2. **(LO 4)** Presented below are three business transactions. List the letters (a), (b), and (c) with columns for assets, liabilities and equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and equity.

a. Purchased equipment on account.

b. Declared and paid cash dividends.

c. Paid expenses in cash.

Solution

Determine effect of transactions on basic accounting equation.

3. **(LO 4)** Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and equity for the following three transactions.

a. Performed accounting services for clients for cash.

b. Borrowed cash from a bank on a note payable.

c. Paid cash for rent for the month.

Solution

Determine where items appear on financial statements.

4. **(LO 5)** Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

a. Dividends.

b. Cash.

c. Salaries and wages expense.

d. Service revenue.

e. Accounts payable.

Solution

Prepare a statement of financial position.

5. (LO 5) Presented below in alphabetical order are statement of financial position items for Feagler Gardening at December 31, 2025. Prepare a statement of financial position following the format of Illustration 1.11.

Accounts receivable	€12,500
Cash	38,000
Notes payable	40,000
Share capital—ordinary	10,500

Solution

Practice Exercises

Analyze the effect of transactions.

1. (LO 3, 4) Selected transactions for Fabulous Flora are listed below.

1. Issued ordinary shares for cash to start business.
2. Purchased equipment on account.
3. Paid salaries.
4. Billed customers for services performed.
5. Received cash from customers billed in (4).
6. Paid dividends.
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and equity. For example, the first answer is: (1) Increase in assets and increase in equity.

Solution

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

2. (LO 3, 4) Alma's Payroll Services entered into the following transactions during May 2025.

1. Purchased computers for $15,000 from Bytes of Data on account.
2. Paid $3,000 cash for May rent on storage space.
3. Received $12,000 cash from customers for contracts billed in April.
4. Performed payroll services for Magic Construction Company for $2,500 cash.
5. Paid Northern Ohio Power Co. $7,000 cash for energy usage in May.
6. Shareholders invested an additional $25,000 in the business.
7. Paid Bytes of Data for the computers purchased in (1) above.
8. Incurred advertising expense for May of $900 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. an increase in assets and a decrease in assets.

b. an increase in assets and an increase in equity.

c. an increase in assets and an increase in liabilities.

d. a decrease in assets and a decrease in equity.

e. a decrease in assets and a decrease in liabilities.

f. an increase in liabilities and a decrease in equity.

g. an increase in equity and a decrease in liabilities.

Solution

Practice Problem

Prepare a tabular summary and financial statements.

(LO 4, 5) Su Feng opens her own law office, Legal Services Ltd., on July 1, 2025. During the first month of operations, the following transactions occurred (NT$ in thousands).

1. Shareholders invested NT$10,000 in cash in exchange for ordinary shares of Legal Services Ltd.
2. Paid NT$800 for July rent on office space.
3. Purchased office equipment on account NT$3,000.
4. Performed legal services for clients for cash NT$1,500.
5. Borrowed NT$700 cash from a bank on a note payable.
6. Performed legal services for client on account NT$2,000.
7. Paid monthly expenses: salaries NT$500 utilities NT$300, and advertising NT$100.

Instructions

a. Prepare a tabular summary of the transactions. (Prepare using NT$ in thousands.)

b. Prepare the income statement, retained earnings statement, and statement of financial position at July 31, 2025, for Legal Services Ltd. (Prepare using NT$ in thousands.)

Solution

Questions

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.

2. Identify and describe the steps in the accounting process.

3.

a. Who are internal users of accounting data?

b. How does accounting provide relevant data to these users?

4. What uses of financial accounting information are made by (a) investors and (b) creditors?

5. What are the four most common types of data analytics, and what basic question does each address?

6. "Bookkeeping and accounting are the same." Do you agree? Explain.

7. Remmers Travel Agency purchased land for £85,000 cash on December 10, 2025. At December 31, 2025, the land's value has increased to £93,000. What amount should be reported for land on Remmers' statement of financial position at December 31, 2025? Explain.

8. What is the monetary unit assumption?

9. What is the economic entity assumption?

10. What are the three basic forms of profit-oriented business organizations?

11. Teresa Alvarez is the owner of a successful printing shop. Recently, her business has been increasing, and Teresa has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Teresa would enjoy if she were to incorporate her business.

12. What is the basic accounting equation?

13.

a. Define the terms assets, liabilities, and equity.

b. What items affect equity?

14. Which of the following items are liabilities of Designer Jewelry Stores?

a. Cash.

b. Accounts payable.

c. Dividends.

d. Accounts receivable.

e. Supplies.

f. Equipment.

g. Salaries and wages payable.

h. Service revenue.

i. Rent expense.

15. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.

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

a. The president of the company dies.

b. Supplies are purchased on account.

c. An employee is fired.

17. Indicate how the following business transactions affect the basic accounting equation.

a. Paid cash for janitorial services.

b. Purchased equipment for cash.

c. Received cash in exchange for ordinary shares.

d. Paid accounts payable in full.

18. Listed below are some items found in the financial statements of Min-Seo Promotions. Indicate in which financial statement(s) the following items would appear.

a. Service revenue.

b. Equipment.

c. Advertising expense.

d. Accounts receivable.

e. Retained earnings.

f. Salaries and wages payable.

19. In February 2025, Xia Sun invested an additional £10,000 in Midtown plc. Midtown's accountant, Jon Shin, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

20. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's statement of financial position." Do you agree? Explain.

21. Jardine plc had an equity balance of £158,000 at the beginning of the period. At the end of the accounting period, the equity balance was £198,000.

a. Assuming no additional investment or distributions during the period, what is the net income for the period?

b. Assuming an additional investment of £13,000 but no distributions during the period, what is the net income for the period?

22. Summarized operations for Carston Gardens for the month of July are as follows.

Revenues recognized: for cash £30,000; on account £70,000.

Expenses incurred: for cash £26,000; on account £40,000.

Indicate for Carston Gardens (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.

23. The basic accounting equation is Assets = Liabilities + Equity. Replacing the words in that equation with numeric amounts, what is **TSMC**'s accounting equation at December 31, 2020? The financial statements of TSMC are presented in Appendix A.

Brief Exercises

Use basic accounting equation.

BE1.1 (LO 3) Presented below is the basic accounting equation (in thousands). Determine the missing amounts.

	Assets	=	Liabilities	+	Equity
a.	¥88,000		¥50,000		?
b.	?		¥45,000		¥70,000
c.	¥94,000		?		¥60,000

Use basic accounting equation.

BE1.2 (LO 3) Given the accounting equation, answer each of the following questions.

a. The liabilities of Shumway Ltd. are £120,000 and the equity is £232,000. What is the amount of Shumway Ltd.'s total assets?

b. The total assets of Shumway Ltd. are £190,000 and its equity is £80,000. What is the amount of its total liabilities?

Use basic accounting equation.

BE1.3 (LO 3) At the beginning of the year, Gilles Plumbers had total assets of €800,000 and total liabilities of €300,000. Answer the following questions. (Note that each situation is independent.)

a. If total assets increased €150,000 during the year and total liabilities decreased €60,000, what is the amount of equity at the end of the year?

b. During the year, total liabilities increased €100,000 and equity decreased €70,000. What is the amount of total assets at the end of the year?

c. If total assets decreased €80,000 and equity increased €120,000 during the year, what is the amount of total liabilities at the end of the year?

Solve expanded accounting equation.

BE1.4 (LO 3) Use the expanded accounting equation to answer each of the following questions.

a. The liabilities of Kumar Company are ₹90,000. Share capital—ordinary is ₹150,000; dividends are ₹40,000; revenues, ₹450,000; and expenses, ₹340,000. What is the amount of Kumar's total assets?

b. The total assets of Kalim Company are ₹57,000. Share capital—ordinary is ₹35,000; dividends are ₹7,000; revenues, ₹52,000; and expenses, ₹35,000. What is the amount of the company's total liabilities?

c. The total assets of Siram Co. are ₹660,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Siram Co.'s equity?

Identify assets, liabilities, and equity.

BE1.5 (LO 3) Indicate whether each of the following items is an asset (A), liability (L), or part of equity (E).

_____ **a.** Accounts receivable.

_____ **b.** Salaries and wages payable.

_____ **c.** Equipment.

_____ **d.** Supplies.

_____ **e.** Share capital—ordinary.

_____ **f.** Notes payable.

Classify items affecting equity.

BE1.6 (LO 3) Classify each of the following items as dividends (D), revenue (R), or expense (E).

_____ **a.** Advertising expense.

_____ **b.** Service revenue.

_____ **c.** Insurance expense.

_____ **d.** Salaries and wages expense.

_____ **e.** Dividends.

_____ **f.** Rent revenue.

_____ **g.** Utilities expense.

Determine effect of transactions on basic accounting equation.

BE1.7 (LO 4) Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and equity. For each column, indicate whether the transactions increased (+), decreased (–), or had no effect (NE) on assets, liabilities, and equity.

a. Purchased supplies on account.

b. Received cash for performing a service.

c. Paid expenses in cash.

Determine effect of transactions on basic accounting equation.

BE1.8 (LO 4) Follow the same format as in BE1.7. Determine the effect on assets, liabilities, and equity of the following three transactions.

a. Shareholders invested cash in the business.

b. Payment of dividends.

c. Received cash from a customer who had previously been billed for services performed.

Determine effect of transactions on equity.

BE1.9 (LO 4) Presented below are three transactions. Mark each transaction as affecting shareholders' investment (I), dividends (D), revenue (R), expense (E), or not affecting equity (NE).

_____ **a.** Received cash for services performed.

_____ **b.** Paid cash to purchase equipment.

_____ **c.** Paid employee salaries.

Prepare a statement of financial position.

BE1.10 (LO 5) In alphabetical order below are statement of financial position items for Grande Ltd. at December 31, 2025. Prepare a statement of financial position, following the format of Illustration 1.11.

Accounts payable	£90,000
Accounts receivable	62,500
Cash	49,000
Share capital—ordinary	21,500

Determine where items appear on financial statements.

BE1.11 (LO 5) Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

_____ **a.** Notes payable.

_____ **b.** Advertising expense.

_____ **c.** Share capital—ordinary.

_____ **d.** Cash.

_____ **e.** Service revenue.

DO IT! Exercises

Review basic concepts.

DO IT! 1.1 (LO 1) Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and examination.
2. The accounting process includes the bookkeeping function.
3. Managerial accounting provides reports to help investors and creditors evaluate a company.
4. The two most common types of external users are investors and creditors.
5. Internal users include human resources managers.

Identify building blocks of accounting.

DO IT! 1.2 (LO 2) Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. IFRS are issued by the FASB.
2. The standards of conduct by which actions are judged as loyal or disloyal are ethics.
3. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
4. Using the historical cost basis means that companies record assets at their cost and continue to report them at their cost over the time the assets are held.
5. The monetary unit assumption requires that companies record only transactions that can be measured in money.

Evaluate effects of transactions on equity.

DO IT! 1.3 (LO 3) Classify the following items as investment by shareholders (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

1. Dividends.
2. Rent revenue.
3. Advertising expense.
4. Shareholders invest cash in business.

Prepare tabular analysis.

DO IT! 1.4 (LO 4) Transactions made by Callahan Ltd., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the accounting equation, similar to that shown in Illustration 1.10.

1. The company performed R20,000 of services for customers, on credit.
2. The company received R20,000 in cash from customers who had been billed for services [in transaction (1)].
3. The company received a bill for R3,200 of advertising but will not pay it until a later date.
4. The company paid a dividend of R5,000 in cash to shareholders.

Determine specific amounts on the financial statements.

DO IT! 1.5 (LO 5) Presented below is selected information related to Tsui Repairs at December 31, 2025. Tsui reports financial information monthly (amounts in thousands).

Accounts Payable	HK$ 3,000	Salaries and Wages Expense	HK$16,500
Cash	6,500	Notes Payable	25,000
Advertising Expense	6,000	Rent Expense	10,500
Service Revenue	53,500	Accounts Receivable	13,500
Equipment	29,000	Dividends	7,500

a. Determine the total assets of Tsui Repairs at December 31, 2025.

b. Determine the net income that Tsui Repairs reported for December 2025.

c. Determine the equity of Tsui Repairs at December 31, 2025.

Exercises

Classify the three activities of accounting.

E1.1 (LO 1) Genesis Company performs the following accounting tasks during the year.

_____ Analyzing and interpreting information.

_____ Classifying economic events.

_____ Explaining uses, meaning, and limitations of data.

_____ Keeping a systematic chronological diary of events.

_____ Measuring events in currency (such as euros or yen).

_____ Preparing accounting reports.

_____ Reporting information in a standard format.

_____ Selecting economic activities relevant to the company.

_____ Summarizing economic events.

Accounting is "an information system that **identifies**, **records**, and **communicates** the economic events of an organization to interested users."

Instructions

Categorize the accounting tasks performed by Genesis as relating to either the identification (I), recording (R), or communication (C) aspects of accounting.

Identify users of accounting information.

E1.2 (LO 1) **a.** The following are users of financial statements.

_____ Customers.

_____ Tax authorities.

_____ Labor unions.

_____ Marketing manager.

_____ Production supervisor.

_____ Financial regulators.

_____ Store manager.

_____ Suppliers.

_____ Vice president of finance.

Instructions

Identify the users as being either **external users** or **internal users**.

b. The following questions could be asked by an internal user or an external user.

_____ Can we afford to give our employees a pay raise?

_____ Did the company earn a satisfactory income?

_____ Do we need to borrow in the near future?

_____ How does the company's profitability compare to other companies?

_____ What does it cost us to manufacture each unit produced?

_____ Which product should we emphasize?

_____ Will the company be able to pay its short-term debts?

Instructions

Identify each of the questions as being more likely asked by an **internal user** or an **external user**.

Discuss how using the historical cost basis makes ethical decision-making either easier or more difficult.

E1.3 (LO 2) Angela Manternach, president of Manternach Designs, has instructed Carla Ruden, the head of the accounting department for Manternach Designs, to report the company's land in the company's accounting reports at its current value of €170,000 instead of its cost of €100,000. Manternach says, "Showing the land at €170,000 will make our company look like a better investment when we try to attract new investors next month."

Instructions

Explain the ethical situation involving Carla Ruden, identifying the stakeholders and the alternatives.

Use accounting concepts.

E1.4 (LO 2) The following situations involve accounting principles and assumptions.

1. Julia A/S owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Julia reports the buildings at their current value in its accounting reports.
2. Dekalb Creations includes in its accounting records only transaction data that can be expressed in terms of money.
3. Omar Shariff, owner of Omar's Oasis, records his personal living costs as expenses of the business.

Instructions

For each of the three situations, determine if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

Classify accounts as assets, liabilities, and equity.

E1.5 (LO 3) Diehl Cleaners has the following statement of financial position items.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Share capital—ordinary

Instructions

Classify each item as an asset, liability, or equity.

Analyze the effect of transactions.

E1.6 (LO 4) Selected transactions for Spring Cruises are listed below.

1. Received cash investment from shareholders to start business in exchange for ordinary shares.
2. Paid monthly rent.
3. Purchased equipment on account.
4. Billed customers for services performed.
5. Paid dividends.
6. Received cash from customers billed in (4).
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and equity. For example, the first answer is: (1) Increase in assets and increase in equity.

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

E1.7 (LO 4) Collins Computer Timeshare entered into the following transactions during May 2025.

1. Purchased computers for R$20,000 from Digital Equipment on account.
2. Paid R$4,000 cash for May rent on storage space.
3. Received R$17,000 cash from customers for contracts billed in April.

4. Performed computer services for Viking Construction for R$4,000 cash.
5. Paid Tri-State Power R$11,000 cash for energy usage in May.
6. Shareholders invested an additional R$29,000 in the business in exchange for ordinary shares.
7. Paid Digital Equipment for the computers purchased in (1) above.
8. Incurred advertising expense for May of R$1,200 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. An increase in assets and a decrease in assets.
b. An increase in assets and an increase in equity.
c. An increase in assets and an increase in liabilities.
d. A decrease in assets and a decrease in equity.
e. A decrease in assets and a decrease in liabilities.
f. An increase in liabilities and a decrease in equity.
g. An increase in equity and a decrease in liabilities.

Analyze transactions and compute net income.

E1.8 (LO 4, 5) Writing An analysis of the transactions made by Kang & Co., a public accounting firm, for the month of August is shown below.

	Assets				= Liabilities	+ Equity				
							Retained Earnings			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Rev.	− Exp.	− Div.	
1.	+ £15,000					+ £15,000				**Issued Shares**
2.	−2,000			+£5,000	+£3,000					
3.	−750		+£750							
4.	+4,600	+£4,500					+ £9,100			**Service Revenue**
5.	−1,500				−1,500					
6.	−2,000								− £2,000	**Dividends**
7.	−650							−£650		**Rent Expense**
8.	+450	−450								
9.	−3,900							−3,900		**Sal./Wages Expense**
10.					+500			−500		**Utilities Expense**

Instructions

a. Describe each transaction that occurred for the month.
b. Determine how much equity increased for the month.
c. Compute the amount of net income for the month.

Prepare financial statements.

E1.9 (LO 5) An analysis of transactions for Kang & Co. was presented in E1.8.

Instructions

Prepare an income statement and a retained earnings statement for August and a statement of financial position at August 31, 2025. Assume that August is the company's first month of business.

Determine net income (or loss).

E1.10 (LO 5) Kinney A.Ş. had the following assets and liabilities on the dates indicated.

December 31	Total Assets	Total Liabilities
2024	₺400,000	₺250,000
2025	₺460,000	₺300,000
2026	₺590,000	₺400,000

Kinney began business on January 1, 2024, with an investment of ₺100,000.

Instructions

From an analysis of the change in equity during the year, compute the net income (or loss) for:

a. 2024, assuming Kinney's paid ₺12,000 in dividends for the year.

b. 2025, assuming shareholders made an additional investment of ₺34,000 and Kinney paid no dividends in 2025.

c. 2026, assuming shareholders made an additional investment of ₺12,000 and Kinney paid dividends of ₺25,000 in 2026.

Analyze financial statements items.

E1.11 (LO 5) Two items are omitted from each of the following summaries of statement of financial position and income statement data for two proprietorships for the year 2025, Greene's Goods and Solar Enterprises.

	Greene's Goods	Solar Enterprises
Beginning of year:		
Total assets	€110,000	€129,000
Total liabilities	85,000	(c)
Total equity	(a)	80,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total equity	40,000	130,000
Changes during year in equity:		
Additional investment	(b)	25,000
Dividends	37,000	(d)
Total revenues	220,000	100,000
Total expenses	175,000	60,000

Instructions

Determine the missing amounts.

Prepare income statement, comprehensive income statement, and retained earnings statement.

E1.12 (LO 5) The following information relates to Karen Weigel Co. for the year 2025.

Retained earnings, January 1, 2025	$42,000	Advertising expense	$ 1,800
Dividends paid during 2025	6,000	Rent expense	10,400
Service revenue	63,600	Utilities expense	3,100
Salaries and wages expense	30,200	Other comprehensive income	460

Instructions

After analyzing the data, prepare (a) an income statement and (b) a comprehensive income statement for the year 2025.

Correct an incorrectly prepared statement of financial position.

E1.13 (LO 5) Lynn Dreise is the bookkeeper for Sanculi SpA. Lynn has been trying to get the statement of financial position of Sanculi to balance correctly. Sanculi's statement of financial position is shown as follows.

Sanculi SpA
Statement of Financial Position
December 31, 2025

Assets		Liabilities	
Equipment	€48,000	Share capital—ordinary	€50,000
Supplies	8,000	Retained earnings	17,500
Cash	14,000	Accounts payable	16,000
Dividends	5,000	Accounts receivable	(8,500)
Total assets	€75,000	Total equity and liabilities	€75,000

Instructions

Prepare a correct statement of financial position.

Compute net income and prepare a statement of financial position.

E1.14 (LO 5) Bear Park Ltd., a camping ground in the Lake District, has compiled the following financial information as of December 31, 2025.

Revenues during 2025—camping fees	£140,000	Notes payable	£ 60,000
Revenues during 2025—general store	47,000	Expenses during 2025	150,000
Accounts payable	11,000	Supplies on hand	2,500
Cash on hand	20,000	Share capital—ordinary	20,000
Original cost of equipment	105,500	Retained earnings	?
Current value of equipment	140,000		

Instructions

a. Determine Bear Park's net income for 2025.

b. Prepare a statement of financial position for Bear Park Ltd. as of December 31, 2025.

Prepare an income statement and comprehensive income statement.

E1.15 (LO 5) Presented below is financial information related to the 2025 operations of Delgado Cruises SA.

Maintenance and repairs expense	R$ 97,000
Utilities expense	10,000
Salaries and wages expense	144,000
Advertising expense	3,500
Ticket revenue	342,000
Other comprehensive income	4,200

Instructions

Prepare the 2025 income statement and comprehensive income statement for Delgado Cruises SA.

Prepare a retained earnings statement.

E1.16 (LO 5) Presented below is information related to Ling an Co.

Retained earnings, January 1, 2025	£ 23,000
Share capital—ordinary	10,000
Legal service revenue—2025	340,000
Total expenses—2025	211,000
Assets, January 1, 2025	95,000
Liabilities, January 1, 2025	62,000
Assets, December 31, 2025	168,000
Liabilities, December 31, 2025	80,000
Dividends—2025	64,000

Instructions

Prepare the 2025 retained earnings statement for Ling an Co.

Prepare a cash flow statement.

E1.17 (LO 5) This information is for Java Growers for the year ended December 31, 2025 (amounts in thousands).

Cash received from revenues from customers	Rp600,000
Cash received for issuance of ordinary shares	280,000
Cash paid for new equipment	95,000
Cash dividends paid	20,000
Cash paid for expenses	430,000
Cash balance 1/1/25	28,000

Instructions

Prepare the 2025 statement of cash flows for Java Growers.

Identify cash flow activities.

E1.18 (LO 5) The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, investments by shareholders, and dividends paid.

Presented below are the following transactions.

1. Shareholders invested €20,000 cash in exchange for ordinary shares.
2. Issued note payable for €12,000 cash.
3. Purchased office equipment for €11,000 cash.
4. Received €15,000 cash for services performed.
5. Paid €1,000 cash for rent.
6. Paid €600 dividend.
7. Paid €5,700 cash for salaries.

Instructions

Classify each of these transactions as operating, investing, or financing activities.

Problems

Analyze transactions and compute net income.

P1.1 (LO 4) On April 1, Julie Chen established Miaoli's Travel Agency. The following transactions were completed during the month.

1. Shareholders invested NT$15,000 cash in the business in exchange for ordinary shares.
2. Paid NT$600 cash for April office rent.
3. Purchased equipment for NT$3,000 cash.

4. Incurred NT$700 of advertising costs for online ads, on account.
5. Paid NT$900 cash for office supplies.
6. Performed services worth NT$10,000: NT$3,000 cash is received from customers, and the balance of NT$7,000 is billed to customers on account.
7. Declared and paid NT$600 dividend.
8. Paid NT$500 of the online advertising amount due in transaction (4).
9. Paid employees' salaries NT$2,500.
10. Received NT$4,000 in cash from customers who have previously been billed in transaction (6).

Instructions

a. Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Share Capital—Ordinary, Revenues, Expenses, and Dividends.

Check figures *provide a key number to let you know you are on the right track.*

a. Total assets NT$20,800

b. From an analysis of the retained earnings columns, compute the net income or net loss for April.

b. Net income NT$6,200

Analyze transactions and prepare income statement, retained earnings statement, and statement of financial position.

P1.2 (LO 4, 5) Ai Fang Co. opened as a new computer services business on August 1, 2025. During August, the following transactions occurred.

1. Shareholders invested ¥20,000 cash in the business in exchange for ordinary shares.
2. Purchased equipment for ¥2,000, paying ¥1,000 in cash and the balance on account.
3. Paid ¥600 cash for August office rent.
4. Purchased ¥500 of supplies on account.
5. Recognized revenue of ¥7,500, of which ¥4,000 is collected in cash with the balance to be collected later.
6. Paid for the supplies purchased in transaction (4).
7. Declared and paid ¥700 dividend.
8. Incurred utility expenses for the month on account ¥270.
9. Paid salaries of ¥2,800 for August.
10. Received ¥2,000 from Standard Bank—money borrowed on a note payable.

Instructions

a. Prepare a tabular analysis of the August transactions. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Share Capital—Ordinary + Revenues – Expenses – Dividends.

a. Total assets ¥26,400

b. Prepare an income statement and a retained earnings statement for August, and a statement of financial position at August 31, 2025, for Ai Fang Co.

b. Net income ¥3,830 Ending retained earnings ¥3,130

Prepare income statement, retained earnings statement, and statement of financial position.

P1.3 (LO 5) On May 1, 2025, Park Flying School Ltd., a company that provides flying lessons, was started with an investment of ₩45,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2025, and the revenues and expenses for the month of May (all amounts in thousands).

Cash	₩ 4,500	Notes Payable	₩28,000
Accounts Receivable	7,420	Rent Expense	1,000
Equipment	64,000	Maintenance and	
Service Revenue	6,800	Repairs Expense	400
Advertising Expense	500	Gasoline Expense	2,500
Accounts Payable	1,400	Utilities Expense	400

No additional investments were made in May, but the company paid dividends of ₩480,000 during the month.

Instructions

a. Prepare an income statement and a retained earnings statement for the month of May and a statement of financial position at May 31. (Show numbers in thousands.)

a. Net income ₩2,000 Total assets ₩75,920

b. Prepare an income statement and a retained earnings statement for May assuming the following data are not included above: (1) ₩900,000 worth of services were performed and billed but not collected at May 31, and (2) ₩1,500,000 of gasoline expense was incurred but not paid.

b. Net income ₩1,400

Analyze transactions and prepare financial statements.

P1.4 (LO 4, 5) Matt Stiner started a delivery service, Stiner Deliveries Ltd., on June 1, 2025. The following transactions occurred during the month of June.

June	1	Shareholders invested £10,000 cash in the business in exchange for ordinary shares.
	2	Purchased a used van for deliveries for £14,000. Matt paid £2,000 cash and signed a note payable for the remaining balance.
	3	Paid £500 for office rent for the month.
	5	Performed services worth £4,800 on account.
	9	Declared and paid £300 in cash dividends.
	12	Purchased supplies for £150 on account.
	15	Received a cash payment of £1,250 for services performed on June 5.
	17	Purchased gasoline for £100 on account.
	20	Received a cash payment of £1,500 for additional services performed.
	23	Made a cash payment of £500 on the note payable.
	26	Paid £250 for utilities.
	29	Paid for the gasoline purchased on account on June 17.
	30	Paid £1,000 for employee salaries.

Instructions

a. Show the effects of the above transactions on the accounting equation using the following format.

	Assets				=	Liabilities		+	Equity					
		Account				Notes	Accounts		Share	Retained Earnings				
Date	Cash	+ Receivable	+ Supplies	+ Equipment	=	Payable	+ Payable	+	Capital	+ Rev.	–	Exp.	–	Div.

Include margin explanations for any changes in the Retained Earnings account in your analysis.

a. Total assets £25,800

b. Prepare an income statement for the month of June.

b. Net income £4,450

c. Prepare a statement of financial position at June 30, 2025.

c. Cash £8,100

Determine financial statement amounts and prepare retained earnings statement.

P1.5 (LO 4, 5) Writing Financial statement information about four different companies is as follows.

	Crosby Company	Stills Company	Nash Company	Young Company
January 1, 2025				
Assets	HK$ 900,000	HK$1,100,000	(g)	HK$1,500,000
Liabilities	650,000	(d)	HK$ 750,000	(j)
Equity	(a)	500,000	450,000	1,000,000
December 31, 2025				
Assets	(b)	1,370,000	2,000,000	(k)
Liabilities	550,000	750,000	(h)	800,000
Equity	400,000	(e)	1,300,000	1,400,000
Equity changes in year				
Additional investment	(c)	150,000	100,000	150,000
Dividends	100,000	(f)	140,000	100,000
Total revenues	3,500,000	4,200,000	(i)	5,000,000
Total expenses	3,300,000	3,850,000	3,420,000	(l)

Instructions

a. Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets − Liabilities = Equity = HK$250,000.)

b. Prepare the retained earnings statement for Stills Company. Assume beginning retained earnings was HK$200,000.

c. Explain the sequence for preparing financial statements and the interrelationship of the retained earnings statement to the income statement and statement of financial position.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT1.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

Refer to TSMC's financial statements and answer the following questions. (Use amounts as reported in New Taiwan dollars.)

a. What were TSMC's total assets at December 31, 2020? At December 31, 2019?

b. How much cash (and cash equivalents) did TSMC have on December 31, 2020?

c. What amount of accounts payable did TSMC report on December 31, 2020? On December 31, 2019?

d. What was TSMC's revenue in 2019? In 2020?

e. What is the amount of the change in TSMC's net income from 2019 to 2020?

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT1.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

Refer to the financial statements and answer the following questions.

a. Based on the information contained in these financial statements, determine the following for each company.

1. Total assets at December 31, 2020.
2. Accounts (trade) receivable, net at December 31, 2020.
3. Net sales for year ended December 31, 2020.
4. Net income (profit) for year ended December 31, 2020.

b. What percentage do receivables represent of total assets for the two companies? What percentage does net income represent of sales (revenue) for the two companies?

Real-World Focus

CT1.3 This exercise will familiarize you with the skills needed (other than accounting skills) to be a successful accountant.

Instructions

Search the Internet for "start here go places" to access resources for future accountants and then answer the following questions.

a. What are the four skill sets that are useful for success in accounting?

b. Why are these skill sets useful for a successful accounting career?

Decision-Making Across the Organization

CT1.4 Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range Ltd. on March 1, 2025, investing £25,000 of their cash savings in the business in exchange for ordinary shares. A caddy shack was constructed for cash at a cost of £8,000, and £800 was spent on golf balls and golf clubs. The company leased five acres of land at a cost of £1,000 per month and paid the first month's rent. During the first month, advertising costs totaled £750, of which £100 was unpaid at March 31, and £500 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, the company paid a total of £1,000 in dividends. A £120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was £18,900.

Anya and Nick thought they had a pretty good first month of operations. But, their estimates of profitability ranged from a loss of £6,100 to net income of £2,480.

Instructions

With the class divided into groups, answer the following.

a. How could the Ramons have concluded that the company operated at a loss of £6,100? Was this a valid basis on which to determine net income?

b. How could the Ramons have concluded that the company operated at a net income of £2,480? (*Hint:* Prepare a statement of financial position at March 31.) Was this a valid basis on which to determine net income?

c. Without preparing an income statement, determine the actual net income for March.

d. What was the revenue recognized in March?

Communication Activity

CT1.5 Erin Danielle, the bookkeeper for Liverpool Ltd., has been trying to determine the correct statement of financial position for the company. The company's statement of financial position is shown below.

Liverpool Ltd.
Statement of Financial Position
For the Month Ended December 31, 2025

Assets		Liabilities	
Equipment	£25,500	Share capital—ordinary	£20,000
Cash	9,000	Accounts receivable	(5,000)
Supplies	3,000	Retained earnings	4,000
Accounts payable	(8,000)	Notes payable	10,500
	£29,500		£29,500

Instructions

Explain to Erin Danielle in an email why the original statement of financial position is incorrect, and what should be done to correct it.

All About You

CT1.6 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity to being both unethical and illegal attempts to mislead investors and creditors.

Instructions

Provide responses for each of the following questions.

a. Discuss whether you think each of the following actions to increase the chances of receiving financial aid is ethical.

   1. Spend the student's assets and income first, before spending parents' assets and income.
   2. Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
   3. State that a truly financially dependent child is independent.
   4. Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

b. What are some reasons why a **company** might want to overstate its earnings?

c. What are some reasons why a **company** might want to understate its earnings?

d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

Considering Environmental, Social, and Governance Reporting

CT1.7 Although **Clif Bar & Company** (USA) is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

Instructions

Go to the Who We Are page at the Clif Bar website and identify the five aspirations.

A Look at U.S. GAAP

> **LEARNING OBJECTIVE 7**
>
> Describe the impact of U.S. accounting standards on global financial reporting.

As indicated in the chapter, IFRSs, which are issued by the IASB, are used by most countries in the world. However, another major standard-setter resides in the United States: the Financial Accounting Standards Board (FASB). Prior to the creation of IFRS, the U.S. accounting standards, referred to as generally accepted accounting principles (GAAP), were used by companies in many countries.

Key Points

While the IASB and the FASB often work together on projects, it appears for the foreseeable future the two Boards will continue to exist independent of one another. It is therefore important for investors, accountants, and students to understand the key similarities and differences that exist between the standards.

Similarities

- GAAP is based on a conceptual framework that is similar to that used to develop IFRS.
- The three common forms of business organization that are presented in the chapter, proprietorships, partnerships, and corporations, are also found in the United States. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurism, the relative use of each form will vary across countries.
- Transaction analysis is basically the same under IFRS and GAAP but, as you will see in later chapters, the different standards may impact how transactions are recorded.
- Financial frauds have occurred at companies such as **Satyam Computer Services** (IND), **Parmalat** (ITA), and **Royal Ahold** (NLD). They have also occurred at large U.S. companies such as **Enron**, **WorldCom**, and **AIG**.

Differences

- The Sarbanes-Oxley Act (SOX) mandates certain internal controls for large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards

centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.

- U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.
- IFRS tends to be less detailed in its accounting and disclosure requirements than GAAP. This difference in approach has resulted in a debate about the merits of "principles-based" (IFRS) versus "rules-based" (GAAP) standards.

GAAP Practice

GAAP Self-Test Questions

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?

a. Mergers and acquisition activity.

b. Financial markets.

c. Multinational corporations.

d. GAAP is widely considered to be a superior reporting system.

Answer

2. The Sarbanes-Oxley Act determines:

a. international tax regulations.

b. internal control standards as enforced by the IASB.

c. internal control standards of U.S. publicly traded companies.

d. U.S. tax regulations.

Answer

3. IFRS is considered to be more:

a. principles-based and less rules-based than GAAP.

b. rules-based and less principles-based than GAAP.

c. detailed than GAAP.

d. None of the answer choices is correct.

Answer

4. Which of the following statements is **false**?

a. GAAP is based on a conceptual framework that is similar to that used to develop IFRS.

b. FASB and the IASB are working on a joint project related to the conceptual framework.

c. Non-U.S. companies that trade shares in U.S. markets must reconcile their accounting with GAAP.

d. Proprietorships, partnerships, and corporations are also found in countries that use IFRS.

Answer

5. Which of the following is **true**?

a. Financial frauds have not occurred in U.S. companies because GAAP has detailed accounting and disclosure requirements.

b. Transaction analysis is basically the same under GAAP and IFRS.

c. IFRS companies have agreed to adopt the Sarbanes-Oxley Act related to internal control in 2025.

d. Foreign companies that trade shares in U.S. markets must reconcile their accounting with the FASB.

Answer

GAAP Exercises

GAAP1.1 Who are the two key international players in the development of international accounting standards? Explain their role.

GAAP1.2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

GAAP1.3 What is the benefit of a single set of high-quality accounting standards?

GAAP1.4 Discuss the potential advantages and disadvantages that countries outside the United States should consider before adopting regulations, such as those in the Sarbanes-Oxley Act, that increase corporate internal control requirements.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP1.5 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Refer to Apple's financial statements to answer the following questions.

a. What were Apple's total assets at September 26, 2020? At September 28, 2019?

b. How much cash did Apple have on September 26, 2020?

c. What amount of accounts payable did Apple report on September 26, 2020? On September 28, 2019?

d. What were Apple's total revenues in 2020? In 2019? In 2018?

e. What is the amount of the change in Apple's net income from 2019 to 2020?

Note

1 The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

2 The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica*, *Geometria*, *Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

3 IFRS uses both the term income and the term revenue to refer to the increase in equity resulting from business activities entered into for the purpose of earning income. To avoid confusion, we will use the term revenue consistently in this text.

4 For the illustrative equations that follow, we use the general account title "Share Capital" instead of "Share Capital—Ordinary" for space considerations.

5 Most companies prepare a statement of changes in equity, which includes the information for the retained earnings statement along with the sources of the changes in the other equity accounts.

CHAPTER 2
The Recording Process



Eva-Katalin/E+/Getty Images

Chapter Preview

In Chapter 1, we analyzed business transactions in terms of the accounting equation, and we presented the cumulative effects of these transactions in tabular form. Imagine a company like **Bank of Taiwan** (TWN) (as in the following Feature Story) using the same tabular format as Softbyte SA to keep track of its transactions. In a single day, Bank of Taiwan engages in thousands of business transactions. To record each transaction this way would be impractical, expensive, and unnecessary. Instead, companies use a set of procedures and records to keep track of transaction data more easily. This chapter introduces and illustrates these basic procedures and records.

Feature Story

Accidents Happen

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

- Does your wallet contain so many cash machine receipts that you've been declared a walking fire hazard?
- Do you verify the accuracy of your bank account about as often as you clean the space behind your refrigerator?
- Do you wait until your debit card is denied before checking the status of your funds?

If you think it is hard to keep track of the many transactions that make up *your* life, imagine what it is like for a major company like **Bank of Taiwan (BOT)** (TWN). If you had your life savings invested at BOT, you might be just slightly displeased if, when you checked your balance online, a message appeared on the screen indicating that your account information was lost.

To ensure the accuracy of your balance and the security of your funds, BOT, like all other companies large and small, relies on a sophisticated accounting information system. That's not to say that BOT or any other company is error-free. In fact, if you've ever overdrawn your bank account because you failed to track your debit card purchases properly, you may take some comfort from one accountant's mistake at **Fidelity Investments** (USA), one of the largest mutual fund investment firms in the world. The accountant failed to include a minus sign while

doing a calculation, making what was actually a $1.3 billion loss look like a $1.3 billion—yes, *billion*—gain! Fortunately, like most accounting errors, it was detected before any real harm was done.

No one expects that kind of mistake at a company like Fidelity, which has sophisticated computer systems and top investment managers. In explaining the mistake to shareholders, a spokesperson wrote, "Some people have asked how, in this age of technology, such a mistake could be made. While many of our processes are computerized, accounting systems are complex and dictate that some steps must be handled manually by our managers and accountants, and people can make mistakes."

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Describe how accounts, debits, and credits are used to record business transactions.	• The account • Debits and credits • Equity relationships • Summary of debit/credit rules	DO IT! 1 Normal Account Balances
LO 2 Indicate how a journal is used in the recording process.	• The recording process • The journal	DO IT! 2 Recording Business Activities
LO 3 Explain how a ledger and posting help in the recording process.	• The ledger • Posting • Chart of accounts • The recording process illustrated • Summary illustration of journalizing and posting	DO IT! 3 Posting
LO 4 Prepare a trial balance.	• Limitations of a trial balance • Locating errors • Currency signs and underlining	DO IT! 4 Trial Balance

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

2.1 Accounts, Debits, and Credits

> **LEARNING OBJECTIVE 1**
>
> Describe how accounts, debits, and credits are used to record business transactions.

The Account

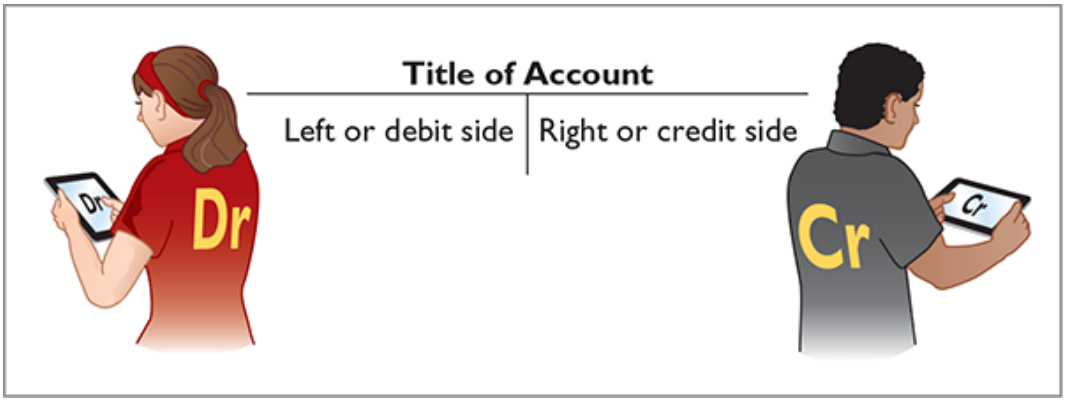
An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or equity item. For example, Softbyte SA (the company discussed in Chapter 1) would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries and Wages Expense, and so on. (Note that whenever we are referring to a specific account, we capitalize the name.)

In its simplest form, an account consists of three parts:

1. A title.
2. A left or debit side.
3. A right or credit side.

Because the format of an account resembles the letter T, we refer to it as a **T-account**. **Illustration 2.1** shows the basic form of an account.

ILLUSTRATION 2.1 Basic form of account



We use this form often throughout this text to explain basic accounting relationships.

Debits and Credits

The term **debit** indicates the left side of an account, and **credit** indicates the right side.

- They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They **do not** mean increase or decrease, as is commonly thought.
- We use the terms **debit** and **credit** repeatedly in the recording process to describe **where** entries are made in accounts.
- For example, the act of entering an amount on the left side of an account is called **debiting** the account. Making an entry on the right side is **crediting** the account.

When comparing the totals of the two sides, an account shows a **debit balance** if the total of the debit amounts exceeds the credits. An account shows a **credit balance** if the credit amounts exceed the debits. Note the position of the debit side and credit side in Illustration 2.1.

The procedure of recording debits and credits in an account is shown in **Illustration 2.2** for the transactions affecting the Cash account of Softbyte SA. The data are taken from the Cash column of the tabular summary in Illustration 1.10.

ILLUSTRATION 2.2 Tabular summary and account form for Softbyte's Cash account

Tabular Summary

Cash
€15,000
–7,000
1,200
1,500
–1,700
–250
600
–1,300
€ 8,050

Account Form

Cash			
(Debits)	15,000	(Credits)	7,000
	1,200		1,700
	1,500		250
	600		1,300
Balance (Debit)	8,050		

Every positive item in the tabular summary represents a receipt of cash. Every negative amount represents a payment of cash. **Notice that in the account form, we record the increases in cash as debits and the decreases in cash as credits.** For example, the €15,000 receipt of cash (in blue) is debited to Cash, and the –€7,000 payment of cash (in red) is credited to Cash.

- Having increases on one side and decreases on the other reduces recording errors and helps in determining the totals of each side of the account as well as the account balance.
- The balance is determined by netting the two sides (subtracting one amount from the other).

Here, the account balance, a debit of €8,050, indicates that Softbyte had €8,050 more increases than decreases in cash. In other words, Softbyte started with a balance of zero and now has €8,050 in its Cash account.

Debit and Credit Procedure

In Chapter 1, you learned the effect of a transaction on the basic accounting equation.

- Each transaction must affect two or more accounts to keep the basic accounting equation in balance. In addition, for each transaction, debits must equal credits.
- The equality of debits and credits provides the basis for the **double-entry system** of recording transactions (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Rules for accounting for specific events sometimes differ across countries. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.**

Under the double-entry system, the dual (two-sided) effect of each transaction is recorded in appropriate accounts. This system provides a logical method for recording transactions and also helps ensure the accuracy of the recorded amounts as well as the detection of errors. If every transaction is recorded with equal debits and credits, the sum of all the debits to the accounts must equal the sum of all the credits.

The double-entry system for determining the equality of the accounting equation is much more efficient than the plus/minus procedure used in Chapter 1. The following discussion illustrates debit and credit procedures in the double-entry system.

Dr./Cr. Procedures for Assets and Liabilities

In Illustration 2.2 for Softbyte, increases in Cash—an asset—are entered on the left side, and decreases in Cash are entered on the right side.

- We know that both sides of the basic equation (Assets = Liabilities + Equity) must be equal.
- It therefore follows that increases and decreases in liabilities have to be recorded **opposite from** increases and decreases in assets.
- Thus, increases in liabilities are entered on the right or credit side, and decreases in liabilities are entered on the left or debit side.

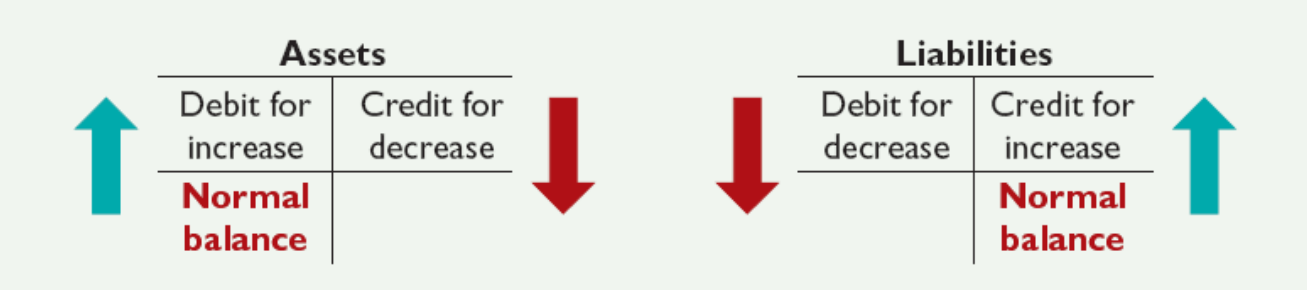
The effects that debits and credits have on assets and liabilities are summarized in **Illustration 2.3**.

ILLUSTRATION 2.3 Debit and credit effects—assets and liabilities

Debits	Credits
Increase assets	Decrease assets
Decrease liabilities	Increase liabilities

Asset accounts normally show debit balances. That is, debits to a specific asset account should exceed credits to that account. Likewise, **liability accounts normally show credit balances**. That is, credits to a liability account should exceed debits to that account. The **normal balance** of an account is on the side where an increase in the account is recorded. **Illustration 2.4** shows the normal balances for assets and liabilities.

ILLUSTRATION 2.4 Normal balances—assets and liabilities



Knowing the normal balance in an account may help you trace errors. For example, a credit balance in an asset account such as Land or a debit balance in a liability account such as Salaries and Wages Payable usually indicates an error. Occasionally, though, an abnormal balance may be correct. The Cash account, for example, will have a credit balance when a company has overdrawn its bank balance by spending more than it has in its account.

Dr./Cr. Procedures for Equity

As Chapter 1 indicated, shareholders' investments and revenues increase equity. Dividends and expenses decrease equity. In a double-entry system, companies keep accounts for each of these types of transactions: share capital—ordinary, retained earnings, dividends, revenues, and expenses.

Share Capital—Ordinary

Companies issue share capital—ordinary in exchange for the owners' investment paid in to the company.

- Credits increase the Share Capital—Ordinary account, and debits decrease it.
- When an owner invests cash in the business in exchange for ordinary shares, the company debits (increases) Cash and credits (increases) Share Capital—Ordinary.

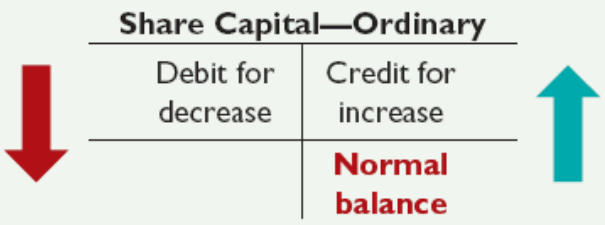
Illustration 2.5 shows the rules of debit and credit for the Share Capital–Ordinary account.

ILLUSTRATION 2.5 Debit and credit effects—share capital—ordinary

Debits	Credits
Decrease Share Capital—Ordinary	Increase Share Capital—Ordinary

We can diagram the normal balance in Share Capital—Ordinary as shown in Illustration 2.6.

ILLUSTRATION 2.6 Normal balance—share capital—ordinary



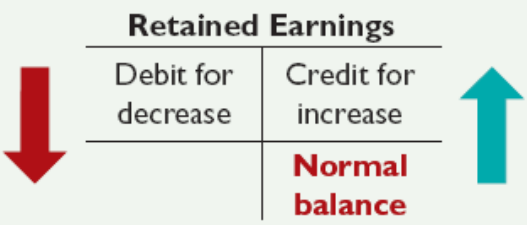
Retained Earnings

Retained earnings is net income that is kept (retained) in the business.

- Retained Earnings represents the portion of equity that the company has accumulated through the profitable operation of the business.
- Credits (net income) increase the Retained Earnings account, and debits (dividends or net losses) decrease it, as Illustration 2.7 shows (see Helpful Hint).

> **HELPFUL HINT**
>
> **The rules for debit and credit and the normal balances of share capital—ordinary and retained earnings are the same as for liabilities.**

ILLUSTRATION 2.7 Debit and credit effects and normal balance—retained earnings



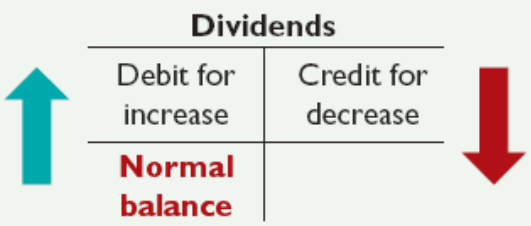
Dividends

A dividend is a company's distribution to its shareholders. The most common form of a distribution is a **cash dividend**.

- Dividends reduce the shareholders' claims on retained earnings.
- Debits increase the Dividends account, and credits decrease it.

Illustration 2.8 shows that this account normally has a debit balance.

ILLUSTRATION 2.8 Debit and credit effect and normal balance—dividends



Revenues and Expenses

The purpose of earning revenues is to benefit the shareholders of the business.

- When a company recognizes revenues, equity increases. Therefore, **the effect of debits and credits on revenue accounts is the same as their effect on Retained Earnings**. That is, revenue accounts are increased by credits and decreased by debits (see Helpful Hint).
- Expenses have the opposite effect. Expenses decrease equity. Since expenses decrease net income and revenues increase it, it is logical that the increase and decrease sides of expense accounts should be the opposite of revenue accounts. Thus, expense accounts are increased by debits and decreased by credits.

> **HELPFUL HINT**
>
> **Because revenues increase equity, a revenue account has the same debit/credit rules as the Retained Earnings account. Expenses have the opposite effect.**

Illustration 2.9 shows the rules of debits and credits for revenues and expenses.

ILLUSTRATION 2.9 Debit and credit effects—revenues and expenses

Debits	Credits
Decrease revenues	Increase revenues
Increase expenses	Decrease expenses

Credits to revenue accounts should exceed debits. Debits to expense accounts should exceed credits. Thus, revenue accounts normally show credit balances, and expense accounts normally show debit balances. Illustration 2.10 shows the normal balances for revenues and expenses.

ILLUSTRATION 2.10 Normal balances—revenues and expenses



Investor Insight

CTBC Brothers

Keeping Score



Mandy Cheng/AFP/
Getty Images

The **CTBC Brothers** (TWN) baseball team probably has these major revenue and expense accounts:

Revenues	Expenses
Admissions (ticket sales)	Players' salaries
Concessions	Administrative salaries
Television and radio	Travel
Advertising	Stadium maintenance

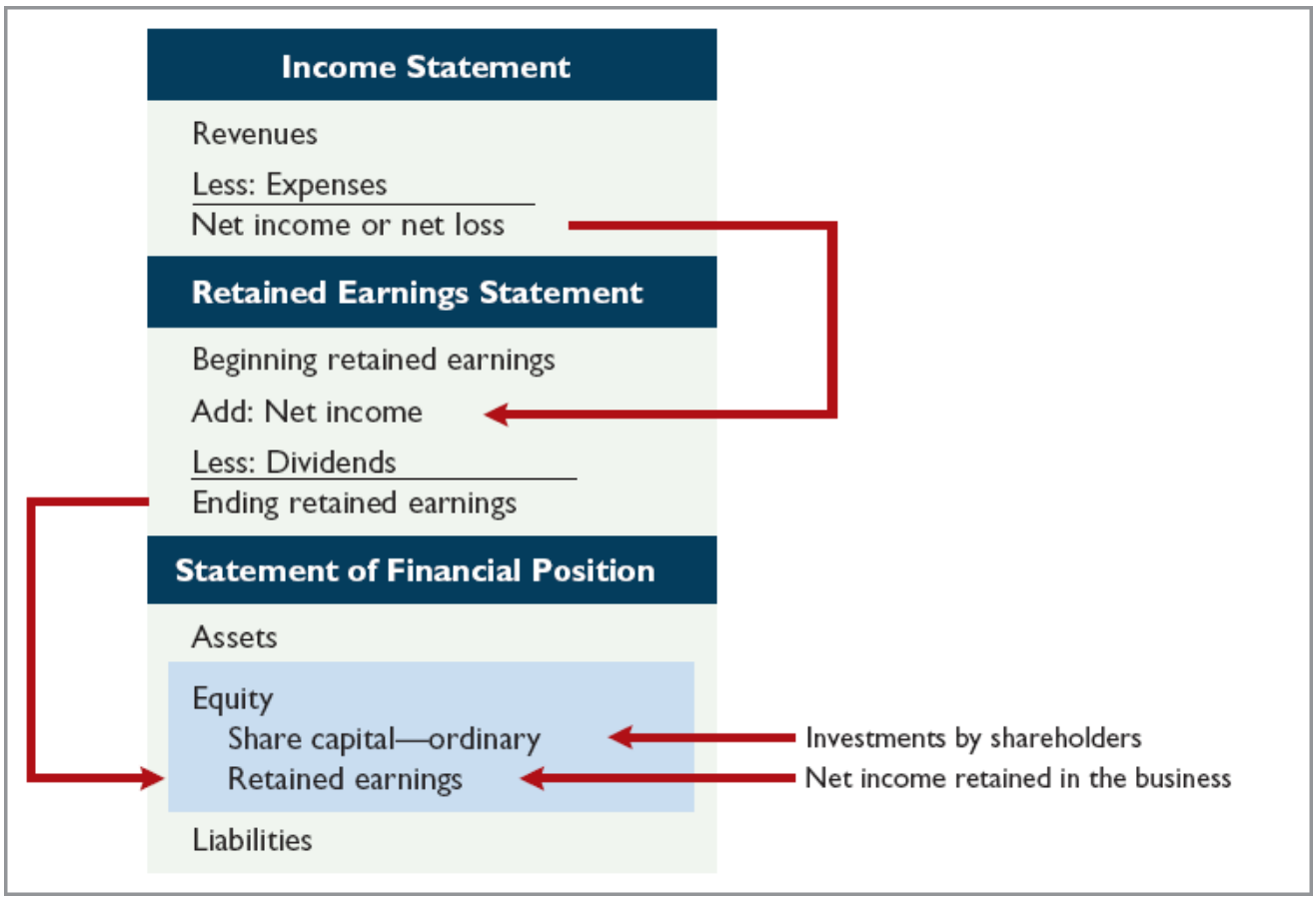
Do you think that the Manchester United (GBR) football (soccer) club would be likely to have the same major revenue and expense accounts as CTBC Brothers?

Answer

Equity Relationships

As Chapter 1 indicated, companies report share capital—ordinary and retained earnings in the equity section of the statement of financial position. They report dividends on the retained earnings statement. And they report revenues and expenses on the income statement. Dividends, revenues, and expenses are eventually transferred to retained earnings at the end of the period. As a result, a change in any one of these three items affects equity. **Illustration 2.11** shows the relationships related to equity.

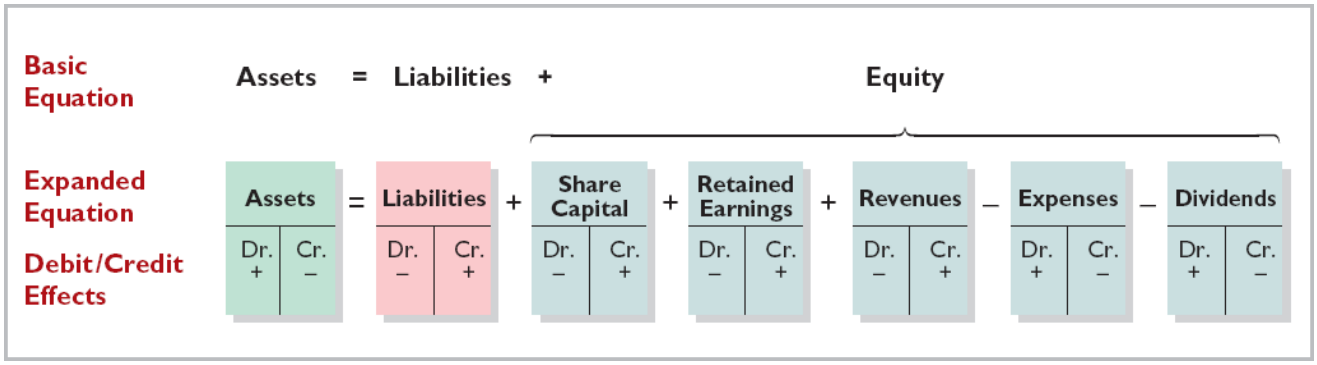
ILLUSTRATION 2.11 **Equity relationships**



Summary of Debit/Credit Rules

Illustration 2.12 shows a summary of the debit/credit rules and effects on each type of account. Study this diagram carefully. It will help you understand the fundamentals of the double-entry system.

ILLUSTRATION 2.12 **Summary of debit/credit rules**



DO IT! 1

Normal Account Balances

Julie Loeng has just rented space in a shopping mall. In this space, she will open a hair salon to be called "Hair It Is." A friend has advised Julie to set up a double-entry set of accounting records in which to record all of her business transactions.

Identify the statement of financial position accounts that Julie will likely need to record the transactions needed to open her business. Indicate whether the normal balance of each account is a debit or a credit.

ACTION PLAN

- **Determine the types of accounts needed. Julie will need asset accounts for each different type of asset invested in the business and liability accounts for any debts incurred.**
- **Understand the types of equity accounts. Only Share Capital—Ordinary will be needed when Julie begins the business. Other equity accounts will be needed later.**

Solution

Related exercise material: BE2.1, BE2.2, DO IT! 2.1, E2.1, E2.2, E2.6, **and** E2.7.

2.2 The Journal

LEARNING OBJECTIVE 2

Indicate how a journal is used in the recording process.

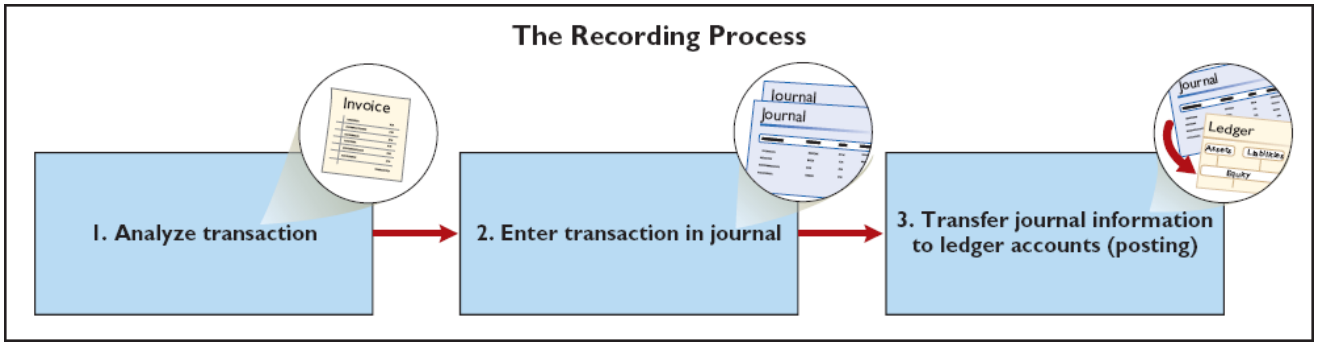


The Recording Process

Although it is possible to enter transaction information directly into the accounts, few businesses do so. Practically every business uses the basic steps shown in Illustration 2.13 in the recording process (an integral part of the accounting cycle):

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

ILLUSTRATION 2.13 The recording process



The steps in the recording process occur repeatedly (see Ethics Note). In Chapter 1, we illustrated the first step, the analysis of transactions, and will give further examples in this and later chapters. The other two steps in the recording process are explained in the next sections.

ETHICS NOTE

International Outsourcing Services, LLC was accused of submitting fraudulent store coupons to companies for reimbursement of as much as $250 million. Use of proper business documents reduces the likelihood of fraudulent activity.

The Journal

Companies initially record transactions in chronological order (the order in which they occur). Thus, the **journal** is referred to as the book of original entry. For each transaction, the journal shows the debit and credit effects on specific accounts (see **Helpful Hint**).

HELPFUL HINT

In a computerized system, journals are kept as files, and accounts are recorded in electronic databases.

Companies may use various kinds of journals, but every company has the most basic form of journal, a **general journal**. Typically, a general journal has spaces for dates, account titles and explanations, references, and two amount columns. See the format of the journal in Illustration 2.14. *Whenever we use the term "journal" in this text, we mean the general journal unless we specify otherwise.*

The journal makes several significant contributions to the recording process:

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

Journalizing

Entering transaction data in the journal is known as **journalizing**. Companies make separate journal entries for each transaction. A complete entry consists of (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction.

Illustration 2.14 shows the technique of journalizing, using the first two transactions of Softbyte SA. Recall that on September 1, shareholders invested €15,000 cash in the corporation in exchange for ordinary shares, and Softbyte purchased computer equipment for €7,000 cash. The number J1 indicates that these two entries are recorded on the first page of the journal. **Illustration 2.14** shows the standard form of journal entries for these two transactions. (The boxed numbers correspond to explanations in the list below the illustration.)

ILLUSTRATION 2.14 Technique of journalizing

GENERAL JOURNAL J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025		5		
Sept. 1	2 Cash		15,000	
1	3 Share Capital—Ordinary			15,000
	4 (Issued shares for cash)			
1	Equipment		7,000	
	Cash			
	(Purchase of equipment for cash)			7,000

1 The date of the transaction is entered in the Date column.

2 The debit account title (that is, the account to be debited) is entered first at the extreme left margin of the column headed "Account Titles and Explanation," and the amount of the debit is recorded in the Debit column.

3 The credit account title (that is, the account to be credited) is indented and entered on the next line in the column headed "Account Titles and Explanation," and the amount of the credit is recorded in the Credit column.

4 A brief explanation of the transaction appears on the line below the credit account title. A space is left between journal entries. The blank space separates individual journal entries and makes the entire journal easier to read.

5 The column titled Ref. (which stands for Reference) is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the individual accounts.

It is important to use correct and specific account titles in journalizing. Erroneous account titles lead to incorrect financial statements. However, some flexibility exists initially in selecting account titles.

- The main criterion is that each title must appropriately describe the content of the account.
- Once a company chooses the specific title to use, it should record under that account title all later transactions involving the account. *In homework problems, you should use specific account titles when they are given.*
- When account titles are not given, you may select account titles that identify the nature and content of each account. The account titles used in journalizing should not contain explanations such as Cash Paid or Cash Received.

Simple and Compound Entries

Some entries involve only two accounts, one debit and one credit. (See, for example, the entries in Illustration 2.14.) This type of entry is called a **simple entry**. Some transactions, however, require more than two accounts in journalizing. An entry that requires three or more accounts is a **compound entry**.

To illustrate, assume that on July 1, Butler Shipping purchases a delivery truck costing £14,000. It pays £8,000 cash now and agrees to pay the remaining £6,000 on account (to be paid later). **Illustration 2.15** shows the compound entry.

ILLUSTRATION 2.15 Compound journal entry

GENERAL JOURNAL J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025				
July 1	Equipment		14,000	
	Cash			8,000
	Accounts Payable			6,000
	(Purchased truck for cash with balance on account)			

In a compound entry, the standard format requires that all debits be listed before the credits.

Accounting Across the Organization

Hain Celestial Group

It Starts with the Transaction



Keith Homan/
Shutterstock

Recording financial transactions in a company's records should be straightforward. If a company determines that a transaction involves revenue, it records revenue. If it has an expense, then it records an expense. However, sometimes this is difficult to do.

For example, for more than a year, **Hain Celestial Group** (USA) (an organic food company) did not provide income information to investors and regulators. The reason given—the organic food company discovered revenue irregularities and said it could not release financial results until it determined when and how to record revenue for certain transactions. When Hain missed four deadlines for reporting earnings information, the food company suffered a 34% drop in its share price. As one analyst noted, it is hard to fathom why a seemingly simple revenue recognition issue took one year to resolve.

In other situations, outright fraud may occur. For example, regulators charged **Obsidian Energy** (CAN) for fraudulently moving millions of dollars in expenses from operating expenses to capital expenditure accounts. By understating reported operating expenses, Obsidian made it appear that it was managing its costs efficiently as well as increasing its income.

These examples demonstrate that "getting the basic transaction right" is the foundation for relevant and reliable financial statements. Starting with an incorrect or inappropriate transaction leads to distortions in the financial statements.

> **Sources:** Based on Shawn Tully, "The Mystery of Hain Celestial's Accounting," *Fortune.com* (August 20, 2016); and Kelly Cryderman, "U.S. Charges Obsidian, Formerly Penn West, with Accounting Fraud," *The Globe and Mail* (June 28, 2017).

Why is it important for companies to record financial transactions completely and accurately?

Answer

DO IT! 2

Recording Business Activities

As president and sole shareholder, Julie Loeng engaged in the following activities in establishing her beauty salon, Hair It Is.

1. Opened a bank account in the name of Hair It Is and deposited €20,000 of her own money in this account in exchange for ordinary shares.
2. Purchased equipment on account (to be paid in 30 days) for a total cost of €4,800.
3. Interviewed three applicants for the position of beautician.

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

ACTION PLAN

- **Understand which activities need to be recorded and which do not. Any that have economic effect should be recorded in a journal.**
- **Analyze the effects of transactions on asset, liability, and equity accounts.**

Solution

Related exercise material: **BE2.3**, **BE2.4**, **BE2.5**, **BE2.6**, **DO IT! 2.2**, **E2.3**, **E2.4**, **E2.5**, **E2.6**, **E2.7**, **E2.8**, **and E2.9**.

2.3 The Ledger and Posting

LEARNING OBJECTIVE 3

Explain how a ledger and posting help in the recording process.



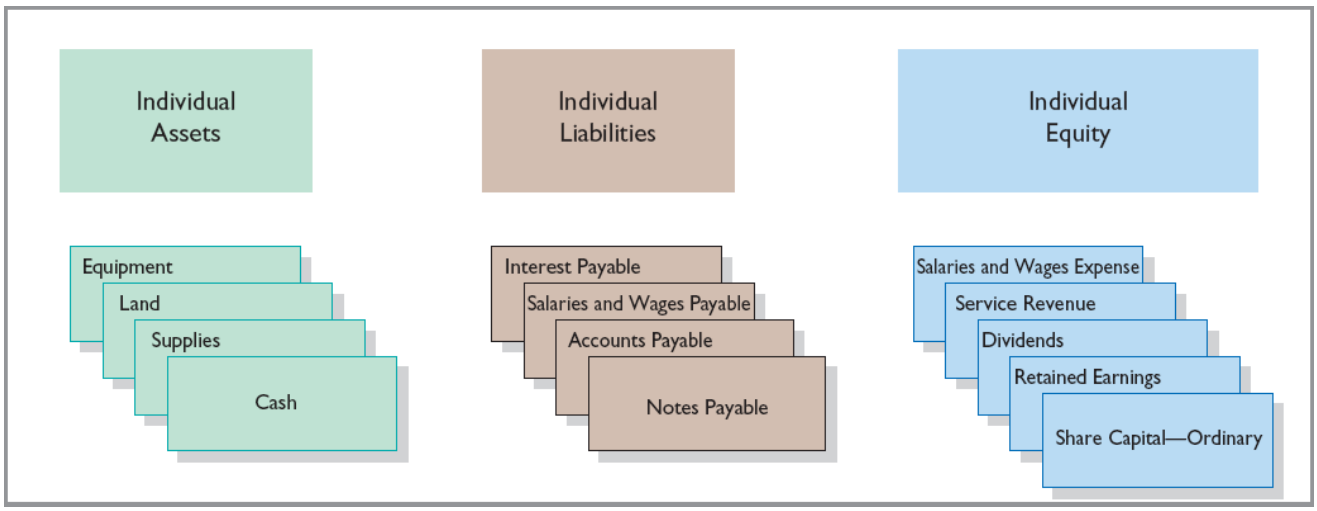
The Ledger

The entire group of accounts maintained by a company is the **ledger**.

- The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.
- Companies may use various kinds of ledgers, but every company has a general ledger.
- A **general ledger** contains all the asset, liability, and equity accounts, as shown in **Illustration 2.16**. *Whenever we use the term "ledger" in this text, we are referring to the general ledger unless we specify otherwise.*

The ledger provides the balance in each of the accounts. For example, the Cash account shows the amount of cash available to meet current obligations. The Accounts Receivable account shows amounts due from customers. Accounts Payable shows amounts owed to creditors. Each account is numbered for easier identification.

ILLUSTRATION 2.16 The general ledger, which contains all of a company's accounts



Ethics Insight

Credit Suisse Group

A Convenient Overstatement



Nuno Silva/
Getty Images

Sometimes a company's investment securities suffer a permanent decline in value below their original cost. When this occurs, the company is supposed to reduce the recorded value of the securities on its statement of financial position ("write them down" in common financial lingo) and record a loss. It appears, however, that during the financial crisis of 2008, employees at some financial institutions chose to look the other way as the value of their investments skidded.

A number of securities traders that worked for the investment bank **Credit Suisse Group** (CHE) were charged with intentionally overstating the value of securities that had suffered declines of approximately $2.85 billion. One reason that they may have been reluctant to record the losses is out of fear that the company's shareholders and clients would panic if they saw the magnitude of the losses. However, personal self-interest might have been equally to blame—the bonuses of the traders were tied to the value of the investment securities.

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

What incentives might employees have to overstate the value of these investment securities on the company's financial statements?

Answer

Standard Form of Account

The simple T-account form used in accounting texts is often very useful for illustration purposes. However, in practice, the account forms used in ledgers are much more structured. **Illustration 2.17** shows a typical form, using assumed data from a cash account.

ILLUSTRATION 2.17 Three-column form of account

CASH NO.101

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
June	1			25,000		25,000
	2				8,000	17,000
	3			4,200		21,200
	9			7,500		28,700
	17				11,700	17,000
	20				250	16,750
	30				7,300	9,450

This format is called the **three-column form of account**. It has three money columns—debit, credit, and balance. The balance in the account is determined after each transaction. Companies use the explanation space and reference columns to provide special information about the transaction.

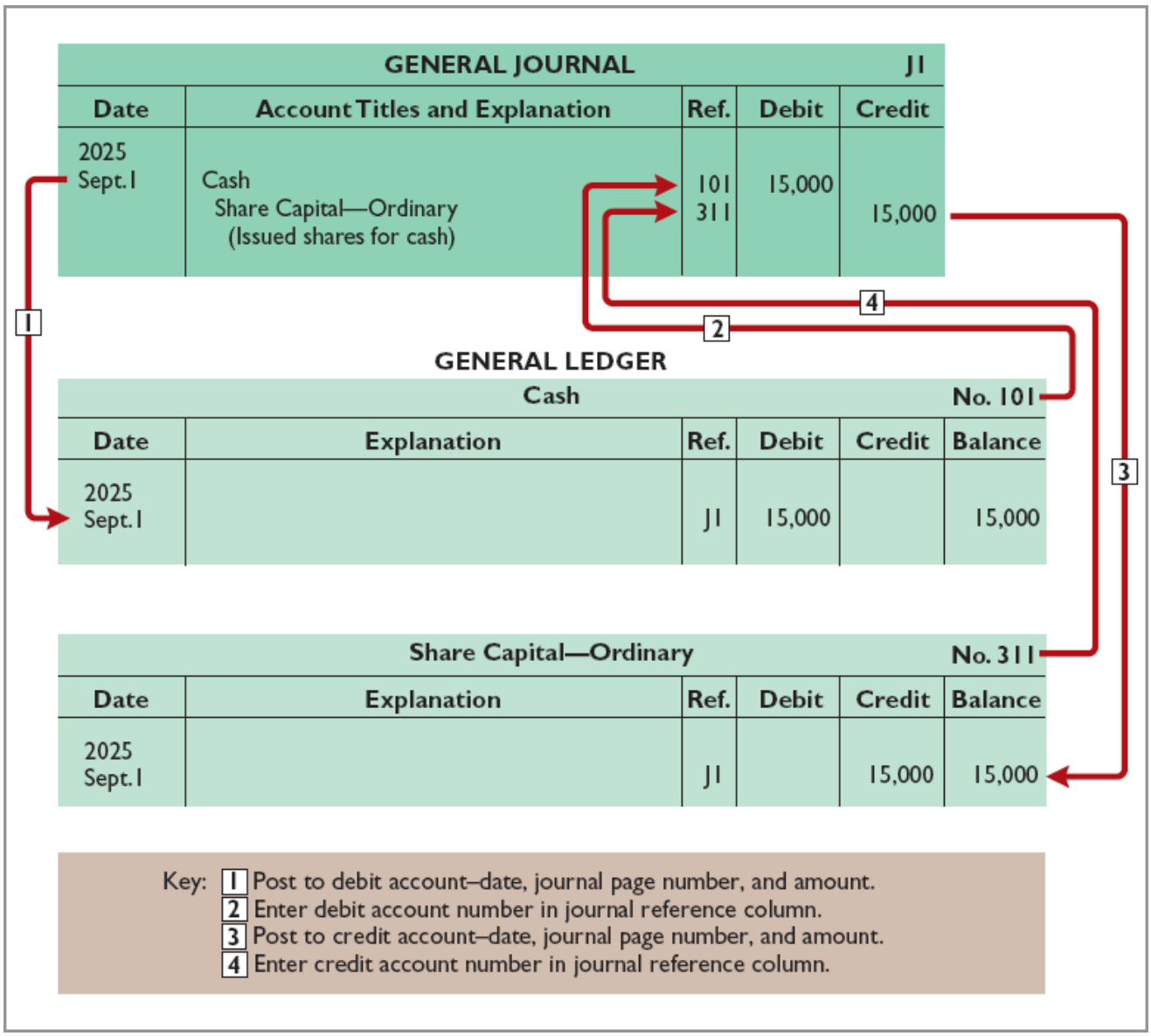
Posting

The procedure of transferring journal entries to the ledger accounts is called **posting**. This phase of the recording process accumulates the effects of journalized transactions into the individual accounts. Posting involves the following steps.

1. In the **ledger**, in the appropriate columns of the account(s) debited, enter the date, journal page, and debit amount shown in the journal.
2. In the reference column of the **journal**, write the account number to which the debit amount was posted.
3. In the **ledger**, in the appropriate columns of the account(s) credited, enter the date, journal page, and credit amount shown in the journal.
4. In the reference column of the **journal**, write the account number to which the credit amount was posted.

Illustration 2.18 shows these four steps using Softbyte SA's first journal entry. The boxed numbers indicate the sequence of the steps.

ILLUSTRATION 2.18 Posting a journal entry



Posting should be performed in chronological order. That is, the company should post all the debits and credits of one journal entry before proceeding to the next journal entry. Postings should be made on a timely basis to ensure that the ledger is up-to-date. *In homework problems, you can journalize all transactions before posting any of the journal entries.*

The reference column of a ledger account indicates the journal page from which the transaction was posted. (After the last entry has been posted, the accountant should scan the reference column **in the journal**, to confirm that all postings have been made.) The explanation space of the ledger account is used infrequently because an explanation already appears in the journal.

Chart of Accounts

The number and type of accounts differ for each company. The number of accounts depends on the amount of detail management desires. For example, the management of one company may want a single account for all types of utility expense. Another may keep separate expense accounts for each type of utility, such as gas, electricity, and water. Similarly, a small company like Softbyte SA will have fewer accounts than a giant company like **Hyundai** (KOR). Softbyte may be able to manage and report its activities in 20 to 30 accounts, while Hyundai may require thousands of accounts to keep track of its worldwide activities.

- Most companies have a **chart of accounts**. This chart lists the accounts and the account numbers that identify their location in the ledger.
- The numbering system that identifies the accounts usually starts with the statement of financial position accounts and follows with the income statement accounts.

In this and the next two chapters, we explain the accounting for Yazici Advertising A.Ş. (a service company). Accounts 101–199 indicate asset accounts; 200–299 indicate liabilities; 301–399 indicate equity accounts; 400–499, revenues; 601–799, expenses; 800–899, other revenues; and 900–999, other expenses. **Illustration 2.19**

shows Yazici's chart of accounts. Accounts listed in red are used in this chapter; accounts shown in black are explained in later chapters.

ILLUSTRATION 2.19 Chart of accounts

Yazici Advertising A.Ş.
Chart of Accounts

Assets	Equity
101 Cash	311 Share Capital—Ordinary
112 Accounts Receivable	320 Retained Earnings
126 Supplies	332 Dividends
130 Prepaid Insurance	350 Income Summary
157 Equipment	**Revenues**
158 Accumulated Depreciation—Equipment	400 Service Revenue
Liabilities	**Expenses**
200 Notes Payable	631 Supplies Expense
201 Accounts Payable	711 Depreciation Expense
209 Unearned Service Revenue	722 Insurance Expense
212 Salaries and Wages Payable	726 Salaries and Wages Expense
230 Interest Payable	729 Rent Expense
	732 Utilities Expense
	905 Interest Expense

You will notice that there are gaps in the numbering system of the chart of accounts for Yazici. Companies leave gaps to permit the insertion of new accounts as needed during the life of the business.

The Recording Process Illustrated

Illustrations 2.20 through 2.29 show the basic steps in the recording process, using the October transactions of Yazici Advertising A.Ş. Yazici's accounting period is a month. A basic analysis and a debit-credit analysis precede the journalizing and posting of each transaction. For simplicity, we use the T-account form in the illustrations instead of the standard account form. Study these transaction analyses carefully.

- **The purpose of transaction analysis is first to identify the type of account involved, and then to determine whether to make a debit or a credit to the account.**
- You should always perform this type of analysis before preparing a journal entry. Doing so will help you understand the journal entries discussed in this chapter as well as more complex journal entries in later chapters (see Helpful Hint).

HELPFUL HINT

Follow these steps:

1. **Determine what type of account is involved.**
2. **Determine what items increased or decreased and by how much.**
3. **Translate the increases and decreases into debits and credits.**

ILLUSTRATION 2.20 **Investment of cash by shareholders**

Transaction

On October 1, C. R. Yazici invests ₺10,000 cash in an advertising company to be known as Yazici Advertising A.Ş.

Basic Analysis

The asset Cash increases ₺10,000; equity (specifically, Share Capital—Ordinary) increases ₺10,000.

Equation Analysis

Assets	=	Liabilities	+	Equity	
Cash	=			Share Capital	
+10,000				+10,000	Issued Shares

Debit–Credit Analysis

Debits increase assets: debit Cash ₺10,000.
Credits increase equity: credit Share Capital—Ordinary ₺10,000.

Journal Entry

Oct. 1	Cash	101	10,000	
	Share Capital—Ordinary (Issued shares for cash)	311		10,000

Posting

Cash 101		Share Capital—Ordinary 311	
Oct. 1 10,000			Oct. 1 10,000

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

Cash Flows
+10,000



ILLUSTRATION 2.21 **Purchase of office equipment**

Transaction

On October 1, Yazici Advertising purchases office equipment costing ₺5,000 by signing a 3-month, 12%, ₺5,000 note payable.

Basic Analysis

The asset Equipment increases ₺5,000; the liability Notes Payable increases ₺5,000.

Equation Analysis

Assets	=	Liabilities	+	Equity
Equipment	=	Notes Payable		
+5,000		+5,000		

Debit–Credit Analysis

Debits increase assets: debit Equipment ₺5,000.
Credits increase liabilities: credit Notes Payable ₺5,000.

Journal Entry

Oct. 1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			

Posting

Equipment	157		Notes Payable	200
Oct. 1 5,000				Oct. 1 5,000

Cash Flows

no effect

ILLUSTRATION 2.22 Receipt of cash for future service

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

Transaction

On October 2, Yazici Advertising receives a ₺1,200 cash advance from R. Knox, a client, for advertising services that are expected to be completed by December 31.

Basic Analysis

The asset Cash increases ₺1,200; the liability Unearned Service Revenue increases ₺1,200 because the service has not been performed yet. That is, when Yazici receives an advance payment, it should record an unearned revenue (a liability) in order to recognize the obligation that exists. Note also that although many liabilities have the word "payable" in their title, unearned revenue is a liability because the obligation is satisfied by providing a product or performing a service.

Equation Analysis

Assets	=	Liabilities	+	Equity
Cash	=	Unearned Service Revenue		
+1,200		+1,200		

Debit–Credit Analysis

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

Journal Entry

Oct. 2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future service)			

Posting

Cash 101		Unearned Service Revenue 209	
Oct. 1 10,000			Oct. 2 1,200
2 1,200			

Cash Flows
+1,200



ILLUSTRATION 2.23 **Payment of monthly rent**

Transaction

On October 3, Yazici Advertising pays office rent for October in cash, ₺900.

Basic Analysis

Rent Expense increases ₺900 because the payment pertains only to the current month; the asset Cash decreases ₺900.

Equation Analysis

Assets	=	Liabilities	+	Equity	
Cash	=			Expenses	
−900				−900	Rent Expense

Debit–Credit Analysis

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

Journal Entry

Oct. 3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200		

Rent Expense			729
Oct. 3	900		

Cash Flows
−900

ILLUSTRATION 2.24 **Payment for insurance**

Transaction

On October 4, Yazici Advertising pays ₺600 for a one-year insurance policy that will expire next year on September 30.

Basic Analysis

The asset Prepaid Insurance increases ₺600 because the payment extends to more than the current month; the asset Cash decreases ₺600. Payments of expenses that will benefit more than one accounting period are prepaid expenses or prepayments. When a company makes a payment, it debits an asset account in order to show the service or benefit that will be received in the future.

Equation Analysis

Assets			=	Liabilities	+	Equity
Cash	+	Prepaid Insurance				
−600		+600				

Debit–Credit Analysis

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

Journal Entry

Oct. 4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			

Posting

Cash 101			
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600

Prepaid Insurance 130			
Oct. 4	600		

Cash Flows
−600



ILLUSTRATION 2.25 Purchase of supplies on credit

Transaction

On October 5, Yazici Advertising purchases an estimated 3-month supply of advertising materials on account from Aero Supply for ₺2,500.

Basic Analysis

The asset Supplies increases ₺2,500; the liability Accounts Payable increases ₺2,500.

Equation Analysis

Assets	=	Liabilities	+	Equity
Supplies	=	Accounts Payable		
+2,500		+2,500		

Debit–Credit Analysis

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

Journal Entry

Oct. 5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			

Posting

Supplies		126
Oct. 5 2,500		

Accounts Payable		201
	Oct. 5	2,500

Cash Flows

no effect

ILLUSTRATION 2.26 Hiring of employees

Event

On October 9, Yazici Advertising hires four employees to begin work on October 15. Each employee is to receive a weekly salary of ₺500 for a 5-day work week, payable every 2 weeks—first payment made on October 26.

Basic Analysis

A business transaction has not occurred. There is only an agreement between the employer and the employees to enter into a business transaction beginning on October 15. Thus, a debit–credit analysis is not needed because there is no accounting entry. (See transaction of October 26 for first entry.)

Cash Flows

no effect

ILLUSTRATION 2.27 **Declaration and payment of dividend**

Transaction

On October 20, Yazici Advertising's board of directors declares and pays a ₺500 cash dividend to shareholders.

Basic Analysis

The Dividends account increases ₺500; the asset Cash decreases ₺500.

Equation Analysis

Assets	=	Liabilities	+	Equity
Cash	=			Dividends
−500				−500

Debit–Credit Analysis

Debits increase dividends: debit Dividends ₺500.
Credits decrease assets: credit Cash ₺500.

Journal Entry

Oct. 20	Dividends	332	500	
	Cash	101		500
	(Declared and paid a cash dividend)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500

Dividends			332
Oct. 20	500		

Cash Flows
−500



ILLUSTRATION 2.28 **Payment of salaries**

Transaction

On October 26, Yazici Advertising owes employee salaries of ₺4,000 and pays them in cash. (See October 9 event.)

Basic Analysis

Salaries and Wages Expense increases ₺4,000; the asset Cash decreases ₺4,000.

Equation Analysis

Assets	=	Liabilities	+	Equity	
Cash	=			Expenses	
−4,000				−4,000	Salaries and Wages Expense

Debit–Credit Analysis

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

Journal Entry

Oct. 26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			

Posting

Cash 101

Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500
		26	4,000

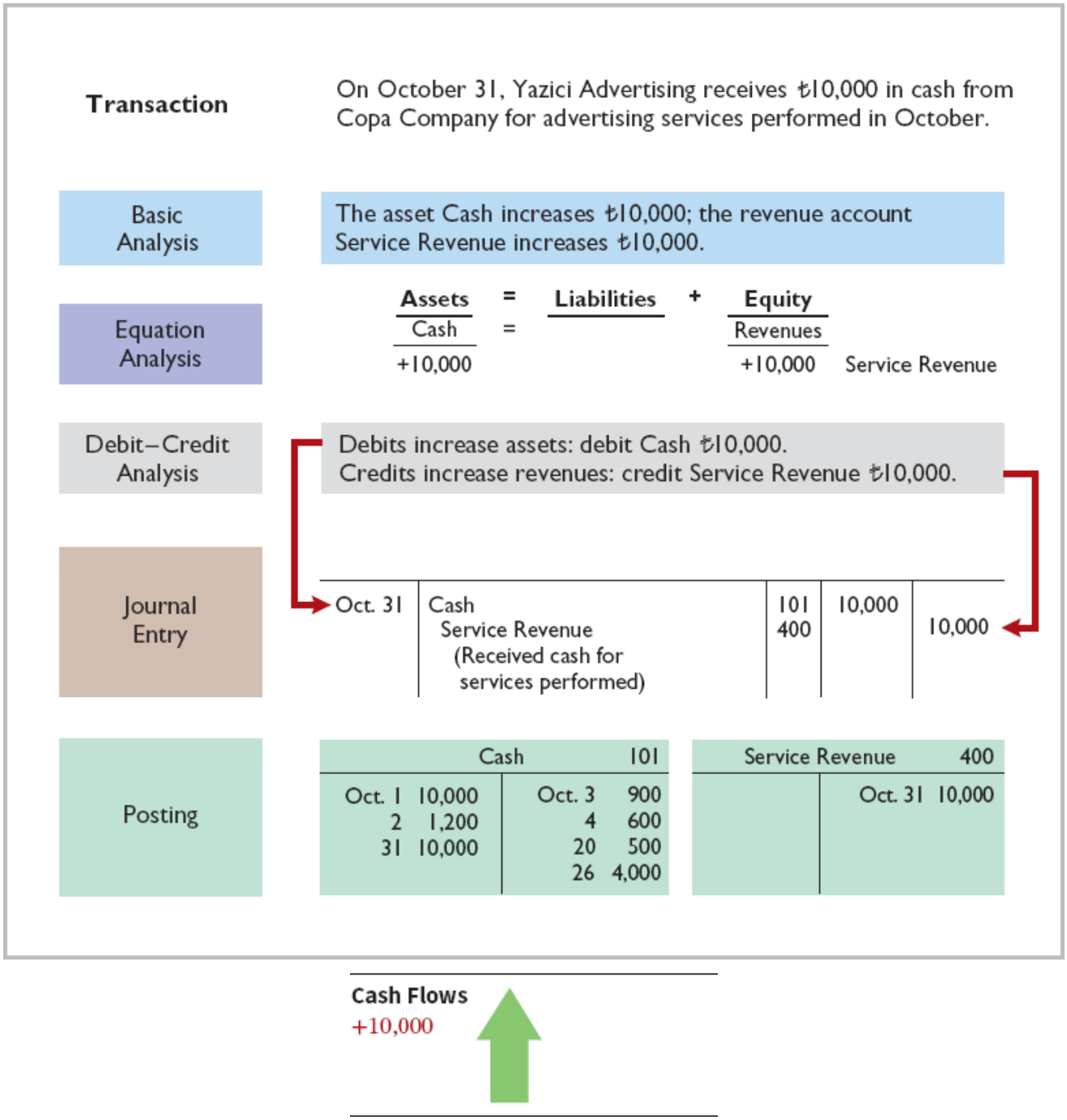
Salaries and Wages Expense 726

Oct. 26	4,000		

Cash Flows
−4,000



ILLUSTRATION 2.29 **Receipt of cash for services provided**



Summary Illustration of Journalizing and Posting

Illustration 2.30 shows the journal for Yazici Advertising A.Ş. for October.

ILLUSTRATION 2.30 General journal entries

GENERAL JOURNAL — PAGE J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025				
Oct. 1	Cash	101	10,000	
	Share Capital—Ordinary	311		10,000
	(Issued shares for cash)			
1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			
2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future services)			
3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			
4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			
5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			
20	Dividends	332	500	
	Cash	101		500
	(Declared and paid a cash dividend)			
26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			
31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

Illustration 2.31 shows the ledger, with all balances in red.

ILLUSTRATION 2.31 General ledger

GENERAL LEDGER

Cash **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		**15,200**

Supplies **No. 126**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1	2,500		**2,500**

Prepaid Insurance **No. 130**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 4		J1	600		**600**

Equipment **No. 157**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	5,000		**5,000**

Notes Payable **No. 200**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		5,000	**5,000**

Accounts Payable **No. 201**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1		2,500	**2,500**

Unearned Service Revenue **No. 209**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 2		J1		1,200	**1,200**

Share Capital—Ordinary **No. 311**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		10,000	**10,000**

Dividends **No. 332**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 20		J1	500		**500**

Service Revenue **No. 400**

Date	Explanation	Ref.	Debit	Credit	Balance

Cash **No. 101**

2025					
Oct. 31		J1		10,000	**10,000**

Salaries and Wages Expense **No. 726**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 26		J1	4,000		**4,000**

Rent Expense **No. 729**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 3		J1	900		**900**

DO IT! 3

Posting

Como SpA recorded the following transactions in a general journal during the month of March

Mar. 4	Cash	2,280	
	Service Revenue		2,280
15	Salaries and Wages Expense	400	
	Cash		400
19	Utilities Expense	92	
	Cash		92

Post these entries to the Cash account of the general ledger to determine the ending balance in cash. The beginning balance in Cash on March 1 was €600.

ACTION PLAN

- **Recall that posting involves transferring the journalized debits and credits to specific accounts in the ledger.**
- **Determine the ending balance by netting the total debits and credits.**

Solution

Related exercise material: BE2.7, BE2.8, DO IT! 2.3, E2.10, E2.11, E2.14, and E2.17.

2.4 The Trial Balance

LEARNING OBJECTIVE 4

Prepare a trial balance.



A trial balance is a list of accounts and their balances at a given time.

- Companies usually prepare a trial balance at the end of an accounting period.
- They list accounts in the order in which they appear in the ledger.
- Debit balances appear in the left column and credit balances in the right column. The totals of the two columns must equal.

The trial balance proves the mathematical equality of debits and credits after posting. Under the double-entry system, this equality occurs when the sum of the debit account balances equals the sum of the credit account balances. **A trial balance may also uncover errors in journalizing and posting.** For example, a trial balance may well have detected the error at **Fidelity Investments** (USA) discussed in the Feature Story. **In addition, a trial balance is useful in the preparation of financial statements**, as we will explain in the next two chapters.

The steps for preparing a trial balance are:

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

Illustration 2.32 shows the trial balance prepared from Yazici Advertising A.Ş.'s ledger. Note that the total debits equal the total credits.

ILLUSTRATION 2.32 A trial balance

Yazici Advertising A.Ş.
Trial Balance
October 31, 2025

	Debit	Credit
Cash	₺15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		₺ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Share Capital—Ordinary		10,000
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	₺28,700	**₺28,700**

A trial balance is a necessary checkpoint for uncovering certain types of errors. For example, if only the debit portion of a journal entry has been posted, the trial balance would bring this error to light.

Limitations of a Trial Balance

A trial balance does not guarantee freedom from recording errors, however (see Ethics Note). Numerous errors may exist even though the totals of the trial balance columns agree. For example, the trial balance may balance even when:

1. A transaction is not journalized.
2. A correct journal entry is not posted.
3. A journal entry is posted twice.
4. Incorrect accounts are used in journalizing or posting.
5. Offsetting errors are made in recording the amount of a transaction.

ETHICS NOTE

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

As long as equal debits and credits are posted, even to the wrong account or in the wrong amount, the total debits will equal the total credits. **The trial balance does not prove that the company has recorded all transactions or that the ledger is correct.**

Locating Errors

Errors in a trial balance generally result from mathematical mistakes, incorrect postings, or simply transcribing data incorrectly. What do you do if you are faced with a trial balance that does not balance? First, determine the amount of the difference between the two columns of the trial balance. After this amount is known, the following steps are often helpful.

1. If the error is €1, €10, €100, or €1,000, re-add the trial balance columns and recompute the account balances.
2. If the error is divisible by 2, scan the trial balance to see whether a balance equal to half the error has been entered in the wrong column.
3. If the error is divisible by 9, retrace the account balances on the trial balance to see whether they are incorrectly copied from the ledger. For example, if a balance was €12 and it was listed as €21, a €9 error has been made. Reversing the order of numbers is called a **transposition error**.
4. If the error is not divisible by 2 or 9, scan the ledger to see whether an account balance in the amount of the error has been omitted from the trial balance, and scan the journal to see whether a posting of that amount has been omitted.

Currency Signs and Underlining

Note that currency signs do not appear in journals or ledgers. Currency signs are typically used only in the trial balance and the financial statements.

- Generally, a currency sign is shown only for the first item in the column and for the total of that column.
- A single line (a totaling rule) is placed under the column of figures to be added or subtracted.
- Total amounts are double-underlined to indicate they are final sums.

Investor Insight

Hypo Real Estate Holding

Why Accuracy Matters



jpa1999/Getty Images

The German Finance minister, Wolfgang Schäuble, said that "statistical and communication problems" were to blame for a €55.5 billion error in the accounts of nationalized property lender **Hypo Real Estate Holding** (DEU). He referred to the error as "an annoying mistake."

This seems to be a considerable understatement considering that the error represented 2.6% of the German gross domestic product. Since the bank had been previously taken over by the German government, the error had resulted in an overstatement of the federal debt of €55.5 billion.

In order for this company to prepare and issue financial statements, its accounting equation (debits and credits) must have been in balance at year-end. How could this error have occurred?

Answer

DO IT! 4

Trial Balance

The following accounts come from the ledger of Bali Beach Supply at December 31, 2025.

157	Equipment	R$88,000	311	Share Capital—Ordinary	R$20,000
332	Dividends	8,000	212	Salaries and Wages	
201	Accounts Payable	22,000		Payable	2,000
726	Salaries and Wages		200	Notes Payable (due in 3 months)	19,000
	Expense	42,000	732	Utilities Expense	3,000
112	Accounts Receivable	4,000	130	Prepaid Insurance	6,000
400	Service Revenue	95,000	101	Cash	7,000

Prepare a trial balance in good form.

ACTION PLAN

- **Determine normal balances and list accounts in the order they appear in the ledger.**
- **Accounts with debit balances appear in the left column, and those with credit balances in the right column.**
- **Total the debit and credit columns to prove equality.**

Solution

Related exercise material: **BE2.9**, **BE2.10**, **DO IT! 2.4**, **E2.11**, **E2.12**, **E2.13**, **E2.15**, **E2.16**, **and** **E2.17**.

Review and Practice

Learning Objectives Review

1 Describe how accounts, debits, and credits are used to record business transactions.

An account is a record of increases and decreases in specific asset, liability, and equity items. The terms debit and credit are synonymous with left and right. Assets, dividends, and expenses are increased by debits and decreased by credits. Liabilities, share capital—ordinary, and revenues are increased by credits and decreased by debits.

2 Indicate how a journal is used in the recording process.

The basic steps in the recording process are (a) analyze each transaction for its effects on the accounts, (b) enter the transaction information in a journal, and (c) transfer the journal information to the appropriate accounts in the ledger.

The initial accounting record of a transaction is entered in a journal before the data are entered in the accounts. A journal (a) discloses in one place the complete effects of a transaction, (b) provides a chronological record of transactions, and (c) prevents or locates errors because the debit and credit amounts for each entry can be easily compared.

3 Explain how a ledger and posting help in the recording process.

The ledger is the entire group of accounts maintained by a company. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances. Posting is the transfer of journal entries to the ledger accounts. This phase of the recording process accumulates the effects of journalized transactions in the individual accounts.

4 Prepare a trial balance.

A trial balance is a list of accounts and their balances at a given time. Its primary purpose is to prove the equality of debits and credits after posting. A trial balance also uncovers errors in journalizing and posting and is useful in preparing financial statements.

Glossary Review

Account
A record of increases and decreases in specific asset, liability, or equity items.

Chart of accounts
A list of accounts and the account numbers that identify their location in the ledger.

Compound entry
A journal entry that involves three or more accounts.

Credit
The right side of an account.

Debit
The left side of an account.

Dividend
A distribution by a company to its shareholders.

Double-entry system
A system that records in appropriate accounts the dual effect of each transaction.

General journal
The most basic form of journal.

General ledger
A ledger that contains all asset, liability, and equity accounts.

Journal
An accounting record in which transactions are initially recorded in chronological order.

Journalizing
The entering of transaction data in the journal.

Ledger
The entire group of accounts maintained by a company.

Normal balance
An account balance on the side where an increase in the account is recorded.

Posting
The procedure of transferring journal entries to the ledger accounts.

Retained earnings
Net income that is kept (retained) in the business.

Simple entry
A journal entry that involves only two accounts.

T-account
The basic form of an account, consisting of (1) a title, (2) a left or debit side, and (3) a right or credit side.

Three-column form of account
A form with columns for debit, credit, and balance amounts in an account.

Trial balance
A list of accounts and their balances at a given time.

Practice Multiple-Choice Questions

1. **(LO 1)** Which of the following statements about an account is **true**?
   a. The right side of an account is the debit, or increase, side.
   b. An account is an individual accounting record of increases and decreases in specific asset, liability, and equity items.
   c. There are separate accounts for specific assets and liabilities but only one account for equity items.
   d. The left side of an account is the credit, or decrease, side.

Solution

2. **(LO 1)** Debits:

a. increase both assets and liabilities.

b. decrease both assets and liabilities.

c. increase assets and decrease liabilities.

d. decrease assets and increase liabilities.

Solution

3. **(LO 1)** A revenue account:

a. is increased by debits.

b. is decreased by credits.

c. has a normal balance of a debit.

d. is increased by credits.

Solution

4. **(LO 1)** Accounts that normally have debit balances are:

a. assets, expenses, and revenues.

b. assets, expenses, and share capital—ordinary.

c. assets, liabilities, and dividends.

d. assets, dividends, and expenses.

Solution

5. **(LO 1)** The expanded accounting equation is:

a. Assets + Liabilities = Share Capital + Retained Earnings + Dividends + Revenues + Expenses.

b. Assets = Liabilities + Share Capital + Retained Earnings + Dividends + Revenues – Expenses.

c. Assets = Liabilities – Share Capital – Retained Earnings – Dividends – Revenues – Expenses.

d. Assets = Liabilities + Share Capital + Retained Earnings + Revenues – Expenses – Dividends.

Solution

6. **(LO 2)** Which of the following is **not** part of the recording process?

a. Analyzing transactions.

b. Preparing an income statement.

c. Entering transactions in a journal.

d. Posting journal entries.

Solution

7. **(LO 2)** Which of the following statements about a journal is **false**?

a. It is not a book of original entry.

b. It provides a chronological record of transactions.

c. It helps to locate errors because the debit and credit amounts for each entry can be readily compared.

d. It discloses in one place the complete effect of a transaction.

Solution

8. **(LO 2)** The purchase of supplies on account should result in:

a. a debit to Supplies Expense and a credit to Cash.

b. a debit to Supplies Expense and a credit to Accounts Payable.

c. a debit to Supplies and a credit to Accounts Payable.

d. a debit to Supplies and a credit to Accounts Receivable.

Solution

9. **(LO 3)** The order of the accounts in the ledger is:

a. assets, revenues, expenses, liabilities, share capital—ordinary, dividends.

b. assets, liabilities, share capital—ordinary, dividends, revenues, expenses.

c. share capital—ordinary, assets, revenues, expenses, liabilities, dividends.

d. revenues, assets, expenses, liabilities, share capital—ordinary, dividends.

Solution

10. **(LO 3)** A ledger:

a. contains only asset and liability accounts.

b. should show accounts in alphabetical order.

c. is a collection of the entire group of accounts maintained by a company.

d. is a book of original entry.

Solution

11. **(LO 3)** Posting:

a. normally occurs before journalizing.

b. transfers ledger transaction data to the journal.

c. is an optional step in the recording process.

d. transfers journal entries to ledger accounts.

Solution

12. **(LO 3)** Before posting a payment of €5,000, the Accounts Payable of Green Grocers had a normal balance of €16,000. The balance after posting this transaction was:

a. €21,000.

b. €5,000.

c. €11,000.

d. cannot be determined.

Solution

13. **(LO 4)** A trial balance:

a. is a list of accounts with their balances at a given time.

b. proves the journalized transactions are correct.

c. will not balance if a correct journal entry is posted twice.

d. proves that all transactions have been recorded.

Solution

14. **(LO 4)** A trial balance will not balance if:

a. a correct journal entry is posted twice.

b. the purchase of supplies on account is debited to Supplies and credited to Cash.

c. a £100 dividend is debited to Dividends for £1,000 and credited to Cash for £100.

d. a £450 payment on account is debited to Accounts Payable for £45 and credited to Cash for £45.

Solution

15. **(LO 4)** The trial balance of Jeong Company had accounts with the following normal balances: Cash $5,000, Service Revenue $85,000, Salaries and Wages Payable $4,000, Salaries and Wages Expense $40,000, Rent Expense $10,000, Share Capital—Ordinary $42,000, Dividends $15,000, and Equipment $61,000. In preparing a trial balance, the total in the debit column is:

a. $131,000.

b. $216,000.

c. $91,000.

d. $116,000.

Solution

Practice Brief Exercises

Identify accounts to be debited and credited.

1. (LO 1) Transactions for Potter Designs for the month of May are presented below. Identify the accounts to be debited and credited for each transaction.

May 1 Shareholders invested £22,000 in the business.

6 Paid office rent of £900.

12 Performed consulting services and billed client £4,400.

18 Purchased equipment on account for £1,200.

Solution

Journalize transactions.

2. (LO 2) Using the data from **Practice Brief Exercise 1**, journalize the transactions (omit explanations).

Solution

Post journal entries to T-accounts.

3. (LO 3) Selected transactions for Santana Outfitters are presented in journal form below. Post the transactions to T-accounts. Make one T-account for each account and determine each account's ending balance.

				J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
June 6	Cash		22,000	
	Share Capital—Ordinary			22,000
	(Issued shares for cash)			
13	Accounts Receivable		8,200	
	Service Revenue			8,200
	(Billed for services performed)			
14	Cash		3,700	
	Accounts Receivable			3,700
	(Received cash in payment of account)			

Solution

Post journal entries to standard form of account.

4. (LO 3) Selected journal entries for Santana Outfitters are presented in **Practice Brief Exercise 3.** Post the transactions using the standard form of account.

Solution

Prepare a trial balance.

5. (LO 4) From the ledger accounts below, prepare a trial balance for Lee Investments at December 31, 2025. List the accounts in the order shown in the text. All account balances are normal (amounts in thousands).

Accounts Receivable	¥10,000	Salaries and Wages Expense	¥ 2,300
Supplies	4,100	Rent Expense	1,200
Accounts Payable	3,500	Share Capital—Ordinary	10,200
Dividends	1,100	Cash	6,000
Service Revenue	11,000		

Solution

Practice Exercises

Analyze and journalize transactions.

1. (LO 2) Presented below is information related to Provence Real Estate Agency (amounts in thousands).

Oct.	1	Henri Bos begins business as a real estate agent with a cash investment of €30,000 in exchange for ordinary shares.
	2	Paid rent, €700, on office space.
	3	Purchases office equipment for €2,800, on account.
	6	Sells a house and lot for Amit Das; bills Amit Das €4,400 for realty services performed.
	27	Pays €1,100 on the balance related to the transaction of October 3.
	30	Receives bill for October utilities, €130 (not paid at this time).

Instructions

Journalize the transactions. (You may omit explanations.)

Solution

Journalize transactions from account data and prepare a trial balance.

2. (LO 2, 4) The T-accounts below summarize the ledger of Depot Company at the end of the first month of operations (in U.S. dollars).

Cash **No. 101**

4/1	16,000	4/15	700
4/12	1,200	4/25	1,600
4/29	900		
4/30	1,600		

Accounts Receivable **No. 112**

4/7	2,900	4/29	900

Supplies **No. 126**

4/4	1,900		

Accounts Payable **No. 201**

4/25	1,600	4/4	1,900

Unearned Service Revenue **No. 209**

		4/30	1,600

Share Capital—Ordinary **No. 311**

		4/1	16,000

Service Revenue **No. 400**

		4/7	2,900
		4/12	1,200

Salaries and Wages Expense **No. 726**

4/15	700		

Instructions

a. Prepare the complete general journal (including explanations).

b. Prepare a trial balance at April 30, 2025.

Solution

Practice Problem

Journalize transactions, post, and prepare a trial balance.

(LO 1, 2, 3, 4) A group of student-investors in Hong Kong opened Campus Laundromat Ltd. on September 1, 2025. During the first month of operations, the following transactions occurred.

Sept.	1	Shareholders invested HK$20,000 cash in the business in exchange for ordinary shares.
	2	The company paid HK$1,000 cash for store rent for September.
	3	Purchased washers and dryers for HK$25,000, paying HK$10,000 in cash and signing a HK$15,000, 6-month, 12% note payable.
	4	Paid HK$1,200 for a one-year accident insurance policy.
	10	Received a bill from the *Daily News* for online advertising of the opening of the laundromat HK$200.
	20	Declared and paid a cash dividend to shareholders of HK$700.
	30	The company determined that cash receipts for laundry services for the month were HK$6,200.

The chart of accounts for the company is the same as that for Yazici Advertising A.Ş. in Illustration 2.19 plus No. 610 Advertising Expense.

Instructions

a. Journalize the September transactions. (Use J1 for the journal page number.)

b. Open ledger accounts and post the September transactions.

c. Prepare a trial balance at September 30, 2025.

Solution

Questions

1. Describe the parts of a T-account.

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

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

4. Melissa Estes, a beginning accounting student, believes debit balances are favorable and credit balances are unfavorable. Is Melissa correct? Discuss.

5. State the rules of debit and credit as applied to (a) asset accounts, (b) liability accounts, and (c) the equity accounts (revenue, expenses, dividends, and share capital—ordinary).

6. What is the normal balance for each of the following accounts? (a) Accounts Receivable. (b) Cash. (c) Dividends. (d) Accounts Payable. (e) Service Revenue. (f) Salaries and Wages Expense. (g) Share Capital—Ordinary.

7. Indicate whether each of the following accounts is an asset, a liability, or an equity account and whether it has a normal debit or credit balance: (a) Accounts Receivable, (b) Accounts Payable, (c) Equipment, (d) Dividends, and (e) Supplies.

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

a. Supplies are purchased on account.

b. Cash is received on signing a note payable.

c. Employees are paid salaries in cash.

9. Indicate whether the following accounts generally will have (a) debit entries only, (b) credit entries only, or (c) both debit and credit entries.

1. Cash.

2. Accounts Receivable.
3. Dividends.
4. Accounts Payable.
5. Salaries and Wages Expense.
6. Service Revenue.

10. What are the basic steps in the recording process?

11. What are the advantages of using a journal in the recording process?

12.

a. When entering a transaction in the journal, should the debit or credit be written first?

b. Which should be indented, the debit or credit?

13. Describe a compound entry, and provide an example.

14.

a. Should business transaction debits and credits be recorded directly in the ledger accounts?

b. What are the advantages of first recording transactions in the journal and then posting to the ledger?

15. The account number is entered as the last step in posting the amounts from the journal to the ledger. What is the advantage of this step?

16. Journalize the following business transactions.

a. Alberto Rivera invests €7,000 cash in the business in exchange for ordinary shares.

b. Insurance of €800 is paid for the year.

c. Supplies of €2,000 are purchased on account.

d. Cash of €8,500 is received for services performed.

17.

a. What is a ledger?

b. What is a chart of accounts and why is it important?

18. What is a trial balance and what are its purposes?

19. Victor Grimm is confused about how accounting information flows through the accounting system. He believes the flow of information is as follows.

a. Debits and credits posted to the ledger.

b. Business transaction occurs.

c. Information entered in the journal.

d. Financial statements are prepared.

e. Trial balance is prepared.

Is Victor correct? If not, indicate to Victor the proper flow of the information.

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

a. The bookkeeper debited Cash for €600 and credited Salaries and Wages Expense for €600 for payment of wages.

b. Cash collected on account was debited to Cash for €800 and Service Revenue was credited for €80.

What would you tell them?

21. What are the normal balances for **TSMC**'s Cash, Accounts Payable, and Interest Expense accounts?

Brief Exercises

Indicate debit and credit effects and normal balance.

BE2.1 (LO 1) For each of the following accounts, indicate the effects of (a) a debit and (b) a credit on the accounts and (c) the normal balance of the account.

1. Accounts Payable.

2. Advertising Expense.
3. Service Revenue.
4. Accounts Receivable.
5. Share Capital—Ordinary.
6. Dividends.

Identify accounts to be debited and credited.

BE2.2 (LO 1) Transactions for Thorn Consulting for the month of June are presented below. Identify the accounts to be debited and credited for each transaction.

June	1	Oleg Thorn invests €5,000 cash in a small welding business in exchange for ordinary shares.
	2	Purchases equipment on account for €3,600.
	3	€800 cash is paid to landlord for June rent.
	12	Sends a bill to K. Johnsen for €400 after completing welding work done on account.

Journalize transactions.

BE2.3 (LO 2) Using the data in BE2.2, journalize the transactions. (You may omit explanations.)

Identify and explain steps in recording process.

BE2.4 (LO 2) Writing Shea Jonas, a fellow student, is unclear about the basic steps in the recording process. Identify and briefly explain the steps in the order in which they occur.

Indicate basic and debit-credit analysis.

BE2.5 (LO 1) Gonzales SA, a financial advising company, has the following transactions during August of the current year, its first month of operations. Indicate (a) the effect on the accounting equation and (b) the debit-credit analysis as illustrated in the text.

Aug.	1	Shareholders invest R$9,000 in cash in exchange for ordinary shares.
	4	Pays insurance in advance for 6 months, R$2,100 cash.
	16	Receives R$3,600 from clients for services performed.
	27	Pays secretary R$1,000 salary.

Journalize transactions.

BE2.6 (LO 2) Using the data in BE2.5, journalize the transactions. (You may omit explanations.)

Post journal entries to T-accounts.

BE2.7 (LO 3) Selected transactions for Wang Enterprises are presented in journal form below. Post the transactions to T-accounts. Make one T-account for each account and determine each account's ending balance.

J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
May 5	Accounts Receivable		5,400	
	Service Revenue			5,400
	(Billed for services performed)			
12	Cash		4,200	
	Accounts Receivable			4,200
	(Received cash in payment of account)			
15	Cash		3,000	
	Service Revenue			3,000
	(Received cash for services performed)			

Post journal entries to standard form of account.

BE2.8 (LO 3) Selected journal entries for Wang Enterprises are presented in BE2.7. Post the transactions using the standard form of account.

Prepare a trial balance.

BE2.9 (LO 4) From the ledger balances given below, prepare a trial balance for Amaro Company at June 30, 2025. List the accounts in the order shown in the text. All account balances are normal.

Accounts Payable $8,100, Cash $5,800, Share Capital—Ordinary $15,000, Dividends $1,200, Equipment $17,000, Service Revenue $10,000, Accounts Receivable $3,000, Salaries and Wages Expense $5,100, and Rent Expense $1,000.

Prepare a correct trial balance.

BE2.10 (LO 4) An inexperienced bookkeeper prepared the following trial balance. Prepare a correct trial balance, assuming all account balances are normal.

Chang Ltd.
Trial Balance
December 31, 2025

	Debit	Credit
Cash	£10,600	
Prepaid Insurance		£ 3,500
Accounts Payable		3,000
Unearned Service Revenue	2,200	
Share Capital—Ordinary		9,000
Dividends		4,500
Service Revenue		25,400
Salaries and Wages Expense	18,600	
Rent Expense		2,400
	£31,400	£47,800

DO IT! Exercises

Identify normal balances.

DO IT! 2.1 (LO 1) Tom Rast has just rented space in a strip mall. In this space, he will open a photography studio, to be called "Picture This!" A friend has advised Tom to set up a double-entry set of accounting records in which to record all of his business transactions.

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

Record business activities.

DO IT! 2.2 (LO 2) Tom Rast engaged in the following activities in establishing his photography studio, Picture This!:

1. Opened a bank account in the name of Picture This! and deposited £6,500 of his own money into this account in exchange for ordinary shares.
2. Purchased photography supplies at a total cost of £1,200. The business paid £400 in cash and the balance is on account.
3. Obtained estimates on the cost of photography equipment from three different manufacturers.

Prepare the journal entries to record the transactions. (You may omit explanations.)

Post transactions.

DO IT! 2.3 (LO 3) Tom Rast recorded the following transactions during the month of April.

April 3	Cash	3,400	
	Service Revenue		3,400
April 16	Rent Expense	700	
	Cash		700
April 20	Salaries and Wages Expense	250	
	Cash		250

Post these entries to the Cash T-account of the general ledger to determine the ending balance in cash. The beginning balance in cash on April 1 was £1,600.

Prepare a trial balance.

DO IT! 2.4 (LO 4) The following accounts are taken from the ledger of Chillin' Company at December 31, 2025.

200	Notes Payable	R$20,000	101	Cash	R$ 6,000
311	Share Capital—Ordinary	28,000	126	Supplies	7,000
157	Equipment	80,000	729	Rent Expense	4,000
332	Dividends	9,000	212	Salaries and Wages Payable	3,000
726	Salaries and Wages Expense	38,000	201	Accounts Payable	11,000
400	Service Revenue	90,000	112	Accounts Receivable	8,000

Prepare a trial balance in good form.

Exercises

Analyze statements about accounting and the recording process.

E2.1 (LO 1) Kim Yi has prepared the following list of statements about accounts.

1. An account is an accounting record of either a specific asset or a specific liability.
2. An account shows only increases, not decreases, in the item it relates to.
3. Some items, such as Cash and Accounts Receivable, are combined into one account.
4. An account has a left, or credit side, and a right, or debit side.
5. A simple form of an account consisting of just the account title, the left side, and the right side, is called a T-account.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Identify debits, credits, and normal balances.

E2.2 (LO 1) Selected transactions for Acosta Decor, an interior design company, in its first month of business are as follows.

Jan.	2	Marie Acosta invested €10,000 cash in business in exchange for ordinary shares.
	3	Purchased a used car for €3,000 cash for use in business.
	9	Purchased supplies on account for €600.
	11	Billed customers €2,400 for services performed.
	16	Paid €350 cash for advertising.
	20	Received €900 cash from customers billed on January 11.
	23	Paid creditor €300 cash on balance owed.
	28	Declared and paid a €1,000 cash dividend.

Instructions

For each transaction, indicate the following.

a. The basic type of account debited and credited (asset, liability, equity).

b. The specific account debited and credited (Cash, Rent Expense, Service Revenue, etc.).

c. Whether the specific account is increased or decreased.

d. The normal balance of the specific account.

Use the following format, in which the January 2 transaction is given as an example.

	Account Debited				Account Credited			
Date	(a) Basic Type	(b) Specific Account	(c) Effect	(d) Normal Balance	(a) Basic Type	(b) Specific Account	(c) Effect	(d) Normal Balance
Jan. 2	Asset	Cash	Increase	Debit	Equity	Share Capital—Ordinary	Increase	Credit

Journalize transactions.

E2.3 (LO 2) Data for Acosta Decor are presented in E2.2.

Instructions

Journalize the transactions using journal page J1. (You may omit explanations.)

Analyze transactions and determine their effect on accounts.

E2.4 (LO 3) The following information relates to Yansheng Real Estate.

Oct.	1	Biao Yansheng begins business as a real estate agent with a cash investment of HK$17,000 in exchange for ordinary shares.
	2	Hires a part-time administrative assistant.
	3	Purchases supplies for HK$1,900, on account.
	6	Sells a house and lot for C. Chow; bills C. Chow HK$3,800 for realty services performed.
	27	Pays HK$1,300 on the balance related to the transaction of October 3.
	30	Pays the administrative assistant HK$2,500 in salary for October.

Instructions

Prepare the debit-credit analysis for each transaction as illustrated in the text.

Journalize transactions.

E2.5 (LO 2) Transaction data for Yansheng Real Estate are presented in E2.4.

Instructions

Journalize the transactions. (You may omit explanations.)

Analyze transactions and journalize.

E2.6 (LO 1, 2) Lennon Industries had the following transactions.

1. Borrowed €5,000 from the bank by signing a note.
2. Paid €3,900 cash for a computer.
3. Purchased €650 of supplies on account.

Instructions

a. Indicate what accounts are increased and decreased by each transaction.

b. Journalize each transaction. (Omit explanations.)

Analyze transactions and journalize.

E2.7 (LO 1, 2) Ong Enterprises had the following selected transactions.

1. Shareholders invested NT$40,000 cash in the business in exchange for ordinary shares.
2. Paid office rent of NT$8,400.
3. Performed consulting services and billed a client NT$52,000.
4. Declared and paid a NT$7,500 dividend.

Instructions

a. Indicate the effect each transaction has on the accounting equation (Assets = Liabilities + Equity), using plus and minus signs.

b. Journalize each transaction. (Omit explanations.)

Journalize a series of transactions.

E2.8 (LO 2) Selected transactions for Sophie's Dog Care are as follows during the month of March.

March	1	Paid monthly rent of $1,200.
	3	Performed services for $160 on account.
	5	Performed services for cash of $75.
	8	Purchased equipment for $600. The company paid cash of $90 and the balance was on account.
	12	Received cash from customers billed on March 3.
	14	Paid salaries and wages to employees of $525.
	22	Paid utilities of $72.
	24	Borrowed $1,500 from Grafton State Bank by signing a note.
	27	Paid $220 to repair service for plumbing repairs.
	28	Paid balance amount owed from equipment purchase on March 8.
	30	Paid $1,800 for six months of insurance.

Instructions

Journalize the transactions. (Omit explanations.)

Record journal entries.

E2.9 (LO 2) On April 1, Adventures Travel Agency began operations. The following transactions were completed during the month.

1. Shareholders invested $24,000 in the business in exchange for ordinary shares.
2. Obtained a bank loan for $7,000 by issuing a note payable.
3. Paid $11,000 cash to buy equipment.
4. Paid $1,200 cash for April office rent.
5. Paid $1,450 for supplies.
6. Purchased $600 of advertising in the *Daily Herald,* on account.
7. Performed services for $18,000: cash of $2,000 was received from customers, and the balance of $16,000 was billed to customers on account.
8. Declared and paid a cash dividend of $400.
9. Paid the utility bill for the month, $2,000.
10. Paid *Daily Herald* the amount due in transaction (6).
11. Paid $40 of interest on the bank loan obtained in transaction (2).
12. Paid employees' salaries and wages, $6,400.
13. Received $12,000 cash from customers billed in transaction (7).

Instructions

Journalize the transactions. (Omit explanations).

Analyze statements about the ledger.

E2.10 (LO 3) Alma Ortiz has prepared the following list of statements about the general ledger.

1. The general ledger contains all the asset and liability accounts but no equity accounts.
2. The general ledger is sometimes referred to as simply the ledger.
3. The accounts in the general ledger are arranged in alphabetical order.
4. Each account in the general ledger is numbered for easier identification.
5. The general ledger is a book of original entry.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Post journal entries and prepare a trial balance.

E2.11 (LO 3, 4) Selected transactions from the journal of Wong Consultants are presented below (amounts in ¥ thousands).

Date	Account Titles and Explanation	Ref.	Debit	Credit
Aug. 1	Cash		5,000	
	Share Capital—Ordinary			5,000
	(Issued shares for cash)			
10	Cash		2,600	
	Service Revenue			2,600
	(Received cash for services performed)			
12	Equipment		5,000	
	Cash			2,300
	Notes Payable			2,700
	(Purchased equipment for cash and notes payable)			
25	Accounts Receivable		1,700	
	Service Revenue			1,700
	(Billed clients for services performed)			
31	Cash		900	
	Accounts Receivable			900
	(Receipt of cash on account)			

Instructions

a. Post the transactions to T-accounts.

b. Prepare a trial balance at August 31, 2025.

Journalize transactions from account data and prepare a trial balance.

E2.12 (LO 2, 4) The T-accounts below summarize the ledger of Negrete Landscaping at the end of the first month of operations (amounts in €).

Cash			No. 101
4/1	14,000	4/15	1,300
4/12	900	4/25	1,500
4/29	400		
4/30	1,000		

Accounts Receivable			No. 112
4/7	3,000	4/29	400

Supplies			No. 126
4/4	1,800		

Accounts Payable			No. 201
4/25	1,500	4/4	1,800

Unearned Service Revenue			No. 209
		4/30	1,000

Share Capital—Ordinary			No. 311
		4/1	14,000

Service Revenue			No. 400
		4/7	3,000
		4/12	900

Salaries and Wages Expense			No. 726
4/15	1,300		

Instructions

a. Prepare the complete general journal (including explanations) from which the postings were made.

b. Prepare a trial balance at April 30, 2025.

Journalize transactions from account data and prepare a trial balance.

E2.13 (LO 2, 4) Presented below is the ledger for Shumway Co. (amounts in thousands of ¥).

Cash			No. 101
10/1	3,000	10/4	400
10/10	750	10/12	1,500
10/10	4,000	10/15	350
10/20	500	10/30	300
10/25	2,000	10/31	500

Share Capital—Ordinary			No. 311
		10/1	3,000
		10/25	2,000

Dividends			No. 332
10/30	300		

Accounts Receivable			No. 112
10/6	800	10/20	500
10/20	940		

Service Revenue			No. 400
		10/6	800
		10/10	750
		10/20	940

Supplies			No. 126
10/4	400		

Salaries and Wages Expense			No. 726
10/31	500		

Equipment			No. 157
10/3	2,000		

Rent Expense			No. 729
10/15	350		

Notes Payable			No. 200
		10/10	4,000

Accounts Payable			No. 201
10/12	1,500	10/3	2,000

Instructions

a. Reproduce the journal entries for the transactions that occurred on October 1, 10, and 20, and provide explanations for each.

b. Determine the October 31 balance for each of the accounts above, and prepare a trial balance at October 31, 2025.

Prepare journal entries and post using standard account form.

E2.14 (LO 2, 3) Selected transactions for Ling Couture during its first month in business are presented below.

Sept.	1	Shareholders invested NT$10,000 cash in the business in exchange for ordinary shares.
	5	Purchased equipment for NT$14,000 paying NT$4,000 in cash and the balance on account.
	25	Paid NT$3,000 cash on balance owed for equipment.
	30	Declared and paid a NT$900 dividend.

Ling's chart of accounts shows No. 101 Cash, No. 157 Equipment, No. 201 Accounts Payable, No. 311 Share Capital—Ordinary, and No. 332 Dividends.

Instructions

a. Journalize the transactions on page J1 of the journal. (Omit explanations.)

b. Post the transactions using the standard account form.

Analyze errors and their effects on trial balance.

E2.15 (LO 4) The bookkeeper for Kang Equipment Repair made a number of errors in journalizing and posting, as described below.

1. A credit posting of $525 to Accounts Receivable was omitted.
2. A debit posting of $750 for Prepaid Insurance was debited to Insurance Expense.
3. A collection from a customer of $100 in payment of its account owed was journalized and posted as a debit to Cash $100 and a credit to Service Revenue $100.

4. A credit posting of $415 to Property Taxes Payable was made twice.
5. A cash purchase of supplies for $250 was journalized and posted as a debit to Supplies $25 and a credit to Cash $25.
6. A debit of $625 to Advertising Expense was posted as $652.

Instructions

For each error:

a. Indicate whether the trial balance will balance.

b. If the trial balance will not balance, indicate the amount of the difference.

c. Indicate the trial balance column that will have the larger total.

Consider each error separately. Use the following form, in which error (1) is given as an example.

	(a)	(b)	(c)
Error	**In Balance**	**Difference**	**Larger Column**
(1)	No	$525	debit

Prepare a trial balance.

E2.16 (LO 4) The accounts in the ledger of Overnite Delivery Service contain the following balances on July 31, 2025 (amounts in thousands).

Accounts Receivable	¥ 7,640	Prepaid Insurance	¥ 1,968
Accounts Payable	8,394	Maintenance and Repairs Expense	961
Cash	?	Service Revenue	10,610
Equipment	45,360	Dividends	700
Gasoline Expense	758	Share Capital—Ordinary	38,000
Utilities Expense	523	Salaries and Wages Expense	4,428
Notes Payable	17,000	Salaries and Wages Payable	815

Instructions

Prepare a trial balance with the accounts arranged as illustrated in the chapter and fill in the missing amount for Cash.

Journalize transactions, post transactions to T-accounts, and prepare trial balance.

E2.17 (LO 2, 3, 4) Beyers Security provides security services. Selected transactions for Beyers are presented below.

Oct.	1	Received $66,000 cash in the business in exchange for ordinary shares.
	2	Hired part-time security consultant. Salary will be $2,000 per month. First day of work will be October 15.
	4	Paid one month of rent for building for $2,000.
	7	Purchased equipment for $18,000, paying $4,000 cash and the balance on account.
	8	Paid $500 for advertising.
	10	Received bill for equipment repair cost of $390.
	12	Provided security services for event for $3,200 on account.
	16	Purchased supplies for $410 on account.
	21	Paid balance due from October 7 purchase of equipment.
	24	Received and paid utility bill for $148.
	27	Received payment from customer for October 12 services performed.
	31	Paid employee salaries and wages of $5,100.

Instructions

a. Journalize the transactions. Do not provide explanations.

b. Post the transactions to T-accounts.

c. Prepare a trial balance at October 31, 2025. (*Hint:* Compute ending balances of T-accounts first.)

Problems

Journalize a series of transactions.

P2.1 (LO 1, 2) Feng Disc Golf Course was opened on March 1. The following selected events and transactions occurred during March (amounts in thousands).

Mar.	1	Lee Feng invested ¥20,000 cash in the business in exchange for ordinary shares.
	3	Purchased Rainbow Golf Land for ¥15,000 cash. The price consists of land ¥12,000, building ¥2,000, and equipment ¥1,000. (Make one compound entry.)
	5	Paid advertising expenses of ¥900.
	6	Paid cash ¥600 for a one-year insurance policy.
	10	Purchased golf discs and other equipment for ¥1,050 from Wang Company payable in 30 days.
	18	Received ¥1,100 in cash for golf fees (Feng records golf fees as service revenue).
	19	Sold 150 coupon books for ¥10 each. Each book contains 4 coupons that enable the holder to play one round of disc golf.
	25	Declared and paid a ¥800 cash dividend.
	30	Paid salaries of ¥250.
	30	Paid Wang Company in full.
	31	Received ¥2,700 cash for golf fees.

Feng Disc Golf uses the following accounts: Cash, Prepaid Insurance, Land, Buildings, Equipment, Accounts Payable, Unearned Service Revenue, Share Capital—Ordinary, Dividends, Service Revenue, Advertising Expense, and Salaries and Wages Expense.

Instructions

Journalize the March transactions.

Journalize transactions, post, and prepare a trial balance.

P2.2 (LO 1, 2, 3, 4) Emily Stansbury is a licensed dentist. During the first month of the operation of her business, the following events and transactions occurred.

April	1	Invested €20,000 cash in her business in exchange for ordinary shares.
	1	Hired a secretary-receptionist at a salary of €700 per week payable monthly.
	2	Paid office rent for the month €1,100.
	3	Purchased dental supplies on account from Dazzle Company €4,000.
	10	Performed dental services and billed insurance companies €5,100.
	11	Received €1,000 cash advance from Leah Mataruka for an implant.
	20	Received €2,100 cash for services performed from Michael Santos.
	30	Paid secretary-receptionist for the month €2,800.
	30	Paid €2,400 to Dazzle for accounts payable due.

Emily uses the following chart of accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 126 Supplies, No. 201 Accounts Payable, No. 209 Unearned Service Revenue, No. 311 Share Capital—Ordinary, No. 400 Service Revenue, No. 726 Salaries and Wages Expense, and No. 729 Rent Expense.

Instructions

a. Journalize the transactions.

b. Post to the ledger accounts.

c. Prepare a trial balance on April 30, 2025.

c. Trial balance totals €29,800

Journalize transactions, post, and prepare a trial balance.

P2.3 (LO 1, 2, 3, 4) Kochi Services was formed on May 1, 2025. The following transactions took place during the first month (amounts in thousands).

Transactions on May 1:

1. Rahul Shah invested ₹40,000 cash in the company in exchange for ordinary shares.

2. Hired two employees to work in the warehouse. They will each be paid a salary of ₹3,050 per month.
3. Signed a 2-year rental agreement on a warehouse; paid ₹24,000 cash in advance for the first year.
4. Purchased furniture and equipment costing ₹30,000. A cash payment of ₹10,000 was made immediately; the remainder will be paid in 6 months.
5. Paid ₹1,800 cash for a one-year insurance policy on the furniture and equipment.

Transactions during the remainder of the month:

6. Purchased basic office supplies for ₹420 cash.
7. Purchased more office supplies for ₹1,500 on account.
8. Total revenues earned were ₹20,000–₹8,000 cash and ₹12,000 on account.
9. Paid ₹400 to suppliers for accounts payable due.
10. Received ₹3,000 from customers in payment of accounts receivable.
11. Received utility bills in the amount of ₹380, to be paid next month.
12. Paid the monthly salaries of the two employees, totaling ₹6,100.

Instructions

a. Prepare journal entries to record each of the events listed. (Omit explanations.)

b. Post the journal entries to T-accounts.

c. Prepare a trial balance as of May 31, 2025.

c. Trial balance totals ₹81,480

Prepare a correct trial balance.

P2.4 (LO 4) The trial balance of De Bortoli Co. shown below does not balance.

De Bortoli Co. Trial Balance June 30, 2025		
	Debit	**Credit**
Cash		$ 3,340
Accounts Receivable	$ 2,812	
Supplies	1,200	
Equipment	2,600	
Accounts Payable		3,666
Unearned Service Revenue	1,100	
Share Capital—Ordinary		8,000
Dividends	800	
Service Revenue		2,480
Salaries and Wages Expense	3,200	
Utilities Expense	810	
	$12,522	$17,486

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

1. Cash received from a customer in payment of its account was debited for $580, and Accounts Receivable was credited for the same amount. The actual collection was for $850.
2. The purchase of a computer on account for $710 was recorded as a debit to Supplies for $710 and a credit to Accounts Payable for $710.
3. Services were performed on account for a client for $980. Accounts Receivable was debited for $980, and Service Revenue was credited for $98.
4. A debit posting to Salaries and Wages Expense of $700 was omitted.
5. A payment of a balance due for $306 was credited to Cash for $306 and credited to Accounts Payable for $360.

6. A dividend of $600 cash was debited to Salaries and Wages Expense for $600 and credited to Cash for $600.

Instructions

Prepare a correct trial balance. (*Hint:* It helps to prepare the correct journal entry for the transaction described and compare it to the mistake made.)

Trial balance totals $15,462

Journalize transactions, post, and prepare a trial balance.

P2.5 (LO 1, 2, 3, 4) The Sun Theater will begin operations in March. The Sun will be unique in that it will show only triple features of sequential theme movies. As of March 1, the ledger of Sun showed No. 101 Cash ₩3,000, No. 140 Land ₩24,000, No. 145 Buildings (concession stand, projection room, ticket booth, and screen) ₩10,000, No. 157 Equipment ₩10,000, No. 201 Accounts Payable ₩7,000, and No. 311 Share Capital—Ordinary ₩40,000. During the month of March, the following events and transactions occurred (amounts in thousands).

Mar.	2	Rented the three *Kung Fu Panda* movies to be shown for the first 3 weeks of March. The film rental was ₩3,500; ₩1,500 was paid in cash and ₩2,000 will be paid on March 10.
	3	Ordered three *Batman* movies to be shown the last 10 days of March. It will cost ₩200 per night.
	9	Received ₩4,300 cash from admissions.
	10	Paid balance due on *Kung Fu Panda* movies rental and ₩2,100 on March 1 accounts payable.
	11	Sun Theater contracted with So Bin to operate the concession stand. Bin is to pay 15% of gross concession receipts, payable monthly, for the rental of the concession stand.
	12	Paid advertising expenses ₩900.
	20	Received ₩5,000 cash from customers for admissions.
	20	Received the *Batman* movies and paid the rental fee of ₩2,000.
	31	Paid salaries of ₩3,100.
	31	Received statement from So Bin showing gross receipts from concessions of ₩6,000 and the balance due to Sun Theater of ₩900 (₩6,000 × 15%) for March. Bin paid one-half the balance due and will remit the remainder on April 5.
	31	Received ₩9,000 cash from customers for admissions.

In addition to the accounts identified above, the chart of accounts includes No. 112 Accounts Receivable, No. 400 Service Revenue, No. 429 Rent Revenue, No. 610 Advertising Expense, No. 726 Salaries and Wages Expense, and No. 729 Rent Expense.

Instructions

a. Enter the beginning balances in the ledger. Insert a check mark (✓) in the reference column of the ledger for the beginning balance.

b. Journalize the March transactions. Sun records admission revenue as service revenue, rental of the concession stand as rent revenue, and film rental expense as rent expense.

c. Post the March journal entries to the ledger. Assume that all entries are posted from page 1 of the journal.

d. Prepare a trial balance on March 31, 2025.

d. Trial balance totals ₩64,100

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT2.1 The financial statements of **TSMC** are presented in Appendix A. The notes accompanying the statements contain the following selected accounts. The complete annual report, including the notes to the financial statements, is available at the company's website.

Accounts Payable	Income Tax Payable
Accounts Receivable	Finance Cost (Interest Expense)
Property, Plant, and Equipment	Inventories

Instructions

a. Answer the following questions.

1. What is the increase and decrease side for each account?

2. What is the normal balance for each account?

b. Identify the probable other account in the transaction and the effect on that account when:

1. Accounts Receivable is decreased.
2. Accounts Payable is decreased.
3. Inventories are increased.

c. Identify the other account(s) that ordinarily would be involved when:

1. Finance Cost (Interest Expense) is increased.
2. Property, Plant, and Equipment is increased.

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT2.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information contained in the financial statements, determine the normal balance of the listed accounts for each company.

Nestlé	Delfi Limited
1. Inventories	1. Trade (Accounts) Receivable
2. Property, Plant, and Equipment	2. Cash and Cash Equivalents
3. Trade and Other Payables	3. Cost of Sales (Expense)
4. Finance Cost (Interest Expense)	4. Revenue

b. Identify the other account ordinarily involved when:

1. Trade (Accounts) Receivable is increased.
2. Salaries and Wages Payable (part of Other Payables) is decreased.
3. Property, Plant, and Equipment is increased.
4. Interest Expense (Finance Cost) is increased.

Real-World Focus

CT2.3 Much information about specific companies is available on the Internet. Such information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Instructions

Go to the **Yahoo! Finance** website and then type in a company name, or use the index to find company name. Choose **Profile** and then perform instructions (a)–(c) below. Next, click on the company's specific industry to identify competitors. Perform instructions (d)–(g) below.

a. What is the company's industry?

b. What was the company's total sales?

c. What was the company's net income?

d. What are the names of four of the company's competitors?

e. Choose one of these competitors.

f. What is this competitor's name? What were its sales? What was its net income?

g. Which of these two companies is larger by size of sales? Which one reported higher net income?

Decision-Making Across the Organization

CT2.4 Amy Torbert manages Hollins Riding Academy. The academy's primary sources of revenue are riding fees and lesson fees, which are paid on a cash basis. Hollins also boards horses for owners, who are billed monthly for boarding fees. In a few cases, boarders pay in advance of expected use. For its revenue transactions, the academy maintains the following accounts: No. 1 Cash, No. 5 Boarding Accounts Receivable, No. 27 Unearned Boarding Revenue, No. 51 Riding Revenue, No. 52 Lesson Revenue, and No. 53 Boarding Revenue.

The academy owns 10 horses, a stable, a riding corral, riding equipment, and office equipment. These assets are accounted for in accounts No. 11 Horses, No. 12 Building, No. 13 Riding Corral, No. 14 Riding Equipment, and No. 15 Office Equipment.

For its expenses, the academy maintains the following accounts: No. 6 Hay and Feed Supplies, No. 7 Prepaid Insurance, No. 21 Accounts Payable, No. 60 Salaries Expense, No. 61 Advertising Expense, No. 62 Utilities Expense, No. 63 Veterinary Expense, No. 64 Hay and Feed Expense, and No. 65 Insurance Expense.

Hollins maintains two equity accounts: No. 50 Share Capital—Ordinary and No. 51 Dividends.

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

May 1	Cash	18,000	
	Share Capital—Ordinary		18,000
	(Invested £18,000 cash in business in exchange for ordinary shares)		
5	Cash	250	
	Riding Revenue		250
	(Received £250 cash for lessons performed)		
7	Cash	500	
	Boarding Revenue		500
	(Received £500 for boarding of horses beginning June 1)		
14	Riding Equipment	800	
	Cash		800
	(Purchased desk and other office equipment for £800 cash)		
15	Salaries Expense		
	Cash	440	
	(Declared and paid cash dividends)		440
20	Cash	148	
	Riding Revenue		184
	(Received £184 cash for riding fees)		
30	Veterinary Expense	75	
	Accounts Payable		75
	(Received bill of £75 from veterinarian for services rendered)		
31	Hay and Feed Expense	1,500	1,500
	Cash		
	(Purchased an estimated 2 months' supply of feed and hay on account for £1,500)		

Instructions

With the class divided into groups, answer the following.

a. Identify each journal entry that is correct. For each journal entry that is incorrect, prepare the entry that should have been made by the bookkeeper.

b. Which of the incorrect entries would prevent the trial balance from balancing?

c. What was the correct net income for May, assuming the bookkeeper reported net income of £4,600 after posting all 50 entries (and the only errors occurred in the items listed above)?

d. What was the correct cash balance at May 31, assuming the bookkeeper reported a balance of £12,475 after posting all 50 entries (and the only errors occurred in the items listed above)?

Communication Activity

CT2.5 Shandler Home Cleaners has two recurring transactions: billing customers for services rendered and paying employee salaries. For example, on March 15, bills totaling €6,000 were sent to customers and €2,000 was paid in salaries to employees.

Instructions

Write an email to your instructor that explains and illustrates the steps in the recording process for each of the March 15 transactions. Use the format illustrated in the text under the heading, "The Recording Process Illustrated."

Ethics Cases

CT2.6 Ellynn Kole is the assistant chief accountant at Doman Circuits, a manufacturer of computer chips and cellular phones. The company presently has total sales of €20 million. It is the end of the first quarter. Ellynn is hurriedly trying to prepare a trial balance so that quarterly financial statements can be prepared and released to management and the regulatory agencies. The total credits on the trial balance exceed the debits by €1,000. In order to meet the 4 p.m. deadline, Ellynn decides to force the debits and credits into balance by adding the amount of the difference to the Equipment account. She chooses Equipment because it is one of the larger account balances; percentage-wise, it will be the least misstated. Ellynn "plugs" the difference! She believes that the difference will not affect anyone's decisions. She wishes that she had another few days to find the error but realizes that the financial statements are already late.

Instructions

a. Who are the stakeholders in this situation?

b. What are the ethical issues involved in this case?

c. What are Ellynn's alternatives?

CT2.7 If you haven't already done so, in the not-too-distant future you will prepare a résumé. In some ways, your résumé is like a company's annual report. Its purpose is to enable others to evaluate your past, in an effort to predict your future.

A résumé is your opportunity to create a positive first impression. It is important that it be impressive—but it should also be accurate. In order to increase their job prospects, some people are tempted to "inflate" their résumés by overstating the importance of some past accomplishments or positions. In fact, you might even think that "everybody does it" and that if you don't do it, you will be at a disadvantage.

Jay Ling, the president and CEO of a well-known electronics retailer, overstated his accomplishments by claiming that he had earned a bachelor's of science degree, when in fact he had not. Apparently, his employer had not done a background check to ensure the accuracy of his résumé. Should the company have fired him?

> **YES:** The company is a publicly traded company. Investors, creditors, employees, and others doing business with the company will not trust it if its leader is known to have poor integrity. The "tone at the top" is vital to creating an ethical organization.
>
> **NO:** Mr. Ling had been a company employee for 11 years. He had served the company in a wide variety of positions, and had earned the position of CEO through exceptional performance. While the fact that he lied 11 years earlier on his résumé was unfortunate, his service since then made this past transgression irrelevant. In addition, the company was in the midst of a massive restructuring, which included closing 700 of its 7,000 stores. It could not afford additional upheaval at this time.

Instructions

Write a response indicating your position regarding this situation. Provide support for your view.

All About You

CT2.8 Every company needs to plan in order to move forward. Its top management must consider where it wants the company to be in three to five years. Like a company, you need to think about where you want to be three to five years from now, and you need to start taking steps now in order to get there.

Instructions

Provide responses to each of the following items.

a. Where would you like to be working in three to five years? Describe your plan for getting there by identifying between five and 10 specific steps that you need to take.

b. In order to get the job you want, you will need a résumé. Your résumé is the equivalent of a company's annual report. It needs to provide relevant and reliable information about your past accomplishments so that employers can decide whether to "invest" in you. Do a search on the Internet to find a good résumé format. What are the basic elements of a résumé?

c. A company's annual report provides information about a company's accomplishments. In order for investors to use the annual report, the information must be reliable; that is, users must have faith that the

information is accurate and believable. How can you provide assurance that the information on your résumé is reliable?

d. Prepare a résumé assuming that you have accomplished the five to 10 specific steps you identified in part (a). Also, provide evidence that would give assurance that the information is reliable.

Considering Environmental, Social, and Governance Reporting

CT2.9 Auditors provide a type of certification of company financial statements. Certification is used in many other aspects of business as well. For example, it plays a critical role in the sustainability movement. The February 7, 2012, issue of the *New York Times* contained an article by S. Amanda Caudill entitled "Better Lives in Better Coffee," which discusses the role of certification in the coffee business.

Instructions

Conduct an Internet search to locate and read the article, and then answer the following questions.

a. The article mentions three different certification types that coffee growers can obtain from three different certification bodies. Using financial reporting as an example, what potential problems might the existence of multiple certification types present to coffee purchasers?

b. According to the author, which certification is most common among coffee growers? What are the possible reasons for this?

c. What social and environmental benefits are coffee certifications trying to achieve? Are there also potential financial benefits to the parties involved?

A Look at U.S. GAAP

LEARNING OBJECTIVE 5

Compare the procedures for the accounting process under IFRS and U.S. GAAP.

Companies that use GAAP follow the same set of procedures and records to keep track of transaction data as do IFRS companies. Thus, the material in Chapter 2 dealing with the account, general rules of debit and credit, and steps in the recording process—the journal, ledger, and chart of accounts—is the same under both GAAP and IFRS.

Key Points

- Both the IASB and FASB go beyond the basic definitions provided in this text for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses. The more substantive definitions, using the FASB definitional structure, are provided in the Chapter 1 *A Look at U.S. GAAP* section.
- For a period of time, the U.S. Securities and Exchange Commission (SEC) was considering adopting IFRS. During this period, the U.S. SEC indicated the following items should be considered in this decision.
  - Whether IFRS is sufficiently developed and consistent in application.
  - Whether the IASB is sufficiently independent.
  - Whether IFRS is established for the benefit of investors.
  - The issues involved in educating investors about IFRS.
  - The impact of a switch to IFRS on U.S. laws and regulations.
  - The impact on companies including changes to their accounting systems, contractual arrangements, company governance, and litigation.
  - The issues involved in educating accountants, so they can prepare statements under IFRS.
- It now appears that the SEC will not adopt IFRS but will permit foreign companies that have securities issued in U.S. markets to provide their financial information to the SEC using IFRS.

Similarities

- A trial balance under GAAP follows the same format as shown in the text.
- As shown in the text, currency signs are typically used only in the trial balance and the financial statements. The same practice is followed under GAAP, using the U.S. dollar. For example, the following income statement for **Apple Inc.** (USA) is denominated in its own currency—the U.S. dollar.

Apple Inc.
Consolidated Statement of Operations
For the Year Ended September 26, 2020
(in millions except per share data)

Net sales	$274,515
Cost of sales	169,559
Gross margin	104,956
Operating expenses:	
Research and development	18,752
Selling, general and administrative	19,916
Total operating expenses	38,668
Operating income	66,288
Other income/(expense), net	803
Income before provision for income taxes	67,091
Provision for income taxes	9,680
Net income	$ 57,411

Differences

- The statement of financial position is often called the balance sheet in the United States.
- Rules for accounting for specific events sometimes differ across countries. For example, IFRS companies rely less on historical cost and more on fair value than U.S. companies. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.

GAAP Practice

GAAP Self-Test Questions

1. Which statement is **correct** regarding GAAP?

a. GAAP reverses the rules of debits and credits, that is, debits are on the right and credits are on the left.

b. GAAP uses the same process for recording transactions as IFRS.

c. The chart of accounts under GAAP is different because revenues follow assets.

d. None of the answer choices is correct.

Answer

2. A trial balance:

a. is the same under GAAP and IFRS.

b. proves that transactions are recorded correctly.

c. proves that all transactions have been recorded.

d. will not balance if a correct journal entry is posted twice.

Answer

3. One difference between GAAP and IFRS is that:

a. IFRS uses accrual-accounting concepts and GAAP uses primarily the cash basis of accounting.

b. GAAP uses a different posting process than IFRS.

c. IFRS uses more fair value measurements than GAAP.

d. the limitations of a trial balance are different between GAAP and IFRS.

Answer

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

a. Currency signs only appear in ledgers and journal entries.

b. Currency signs are only shown in the trial balance.

c. Currency signs are shown for all compound journal entries.

d. Currency signs are shown in trial balances and financial statements.

Answer

GAAP Exercise

GAAP2.1 Describe some of the issues the U.S. SEC must consider in deciding whether the United States should adopt IFRS.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP2.2 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

a. Apple has the following selected accounts:

Accounts Payable	Inventories
Accounts Receivable	Net Sales
Property, Plant, and Equipment, net	Research and Development

1. What is the increase and decrease side of each account?
2. What is the normal balance for each account?

b. Identify the probable other account in the transaction and the effect on that account when:

1. Accounts Receivable is decreased.
2. Accounts Payable is decreased.
3. Inventories is increased.

CHAPTER 3
Adjusting the Accounts



BJI/Lane Oatey/Getty Images

Chapter Preview

In Chapter 1, you learned a neat little formula: Net income = Revenues – Expenses. In Chapter 2, you learned some rules for recording revenue and expense transactions. Guess what? Things are not really that nice and neat. In fact, it is often difficult for companies to determine in what time period they should report some revenues and expenses. In other words, in measuring net income, timing is everything.

Feature Story

What Was Your Profit?

The accuracy of the financial reporting system depends on answers to a few fundamental questions: At what point has revenue been recognized? When have expenses really been incurred?

Unfortunately, all too often companies overstate their revenues. For example, during the dot-com boom, most dot-coms earned a large percentage of their revenue from selling advertising space on their websites. To boost reported revenue, some dot-coms began swapping website ad space. Company A would put an ad for its website on company B's website, and company B would put an ad for its website on company A's website. No money changed hands, but each company recorded revenue (for the value of the space that it gave the other company on its site). This practice did little to boost net income, and it resulted in no additional cash flow—but it did boost *reported revenue*. Regulators eventually put an end to this misleading practice.

Another type of transgression results from companies recording revenues or expenses in the wrong year. In fact, shifting revenues and expenses is one of the most common abuses of financial accounting. For example, **Tesco** (GBR), the large British grocery chain, was forced the lower its previously reported profits by £263 million, due to improper expense recognition related to its suppliers.

Perhaps one of the most unusual cases of reporting expenses in the wrong period was revealed by **Olympus Corporation** (JPN). The company admitted that it had covered up investment losses for more

than a decade. It then tried to eliminate the losses from the books through a fraudulent process of overstating the price of some acquired assets and then writing down those assets in subsequent adjusting entries.

Unfortunately, revelations such as these have become all too common in the business world. It is no wonder that a survey of affluent investors reported that 85% of respondents believed that there should be tighter regulation of financial disclosures; 66% said they did not trust the management of publicly traded companies.

Why do so many companies violate basic financial reporting rules and sound ethics? Many speculate that executives are under increasing pressure to meet higher and higher earnings expectations. If actual results aren't as good as hoped for, some give in to temptation and "adjust" their numbers to meet market expectations.

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Explain the accrual basis of accounting and the reasons for adjusting entries.	• Fiscal and calendar years • Accrual- vs. cash-basis accounting • Recognizing revenues and expenses • Need for adjusting entries • Types of adjusting entries	DO IT! 1 Timing Concepts
LO 2 Prepare adjusting entries for deferrals.	• Prepaid expenses • Unearned revenues	DO IT! 2 Adjusting Entries for Deferrals
LO 3 Prepare adjusting entries for accruals.	• Accrued revenues • Accrued expenses • Summary of basic relationships	DO IT! 3 Adjusting Entries for Accruals
LO 4 Describe the nature and purpose of an adjusted trial balance.	• Preparing the adjusted trial balance • Preparing financial statements	DO IT! 4 Trial Balance

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

3.1 Accrual-Basis Accounting and Adjusting Entries

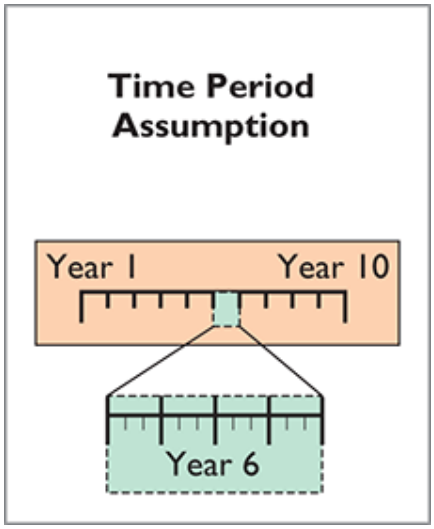
> **LEARNING OBJECTIVE 1**
>
> Explain the accrual basis of accounting and the reasons for adjusting entries.

If we could wait to prepare financial statements until a company ended its operations, no adjustments would be needed. At that point, we could easily determine its final statement of financial position and the amount of lifetime income it earned.

- However, most companies need feedback about how well they are performing during a period of time. For example, management usually wants monthly financial statements. Taxing agencies require all businesses to file annual tax returns.
- Therefore, **accountants divide the economic life of a business into artificial time periods**. This convenient assumption is referred to as the **time period assumption** (see **Alternative Terminology**).

> **ALTERNATIVE TERMINOLOGY**
>
> **The time period assumption is also called the *periodicity assumption*.**

Many business transactions affect more than one of these arbitrary time periods. For example, the airplanes purchased by **Cathay Pacific** (HKG) five years ago are still in use today. It would not make sense to expense the full cost of the airplanes at the time of purchase because they will be used for many subsequent periods. Instead, companies must therefore allocate the costs to the periods of use (what portion of the cost of the airplanes should be recorded as an expense each period?).



Fiscal and Calendar Years

Both small and large companies prepare financial statements periodically in order to assess their financial condition and results of operations. **Accounting time periods are generally a month, a quarter, or a year.**

- Monthly and quarterly time periods are called **interim periods**. Most large companies must prepare both quarterly and annual financial statements.
- An accounting time period that is one year in length is a **fiscal year**. A fiscal year usually begins with the first day of a month and ends 12 months later on the last day of a month.
- Many businesses use the **calendar year** (January 1 to December 31) as their accounting period. Some do not.

Companies whose fiscal year differs from the calendar year include **Sony** (JPN) and **India Adani** (IND), which both have fiscal years ending March 31. Sometimes a company's year-end will vary from year to year. For example, **JJB Sports**' (GBR) fiscal year ends on the Sunday before January 31, resulting in accounting periods of either 52 or 53 weeks.

Accrual- versus Cash-Basis Accounting

What you will learn in this chapter is **accrual-basis accounting**.

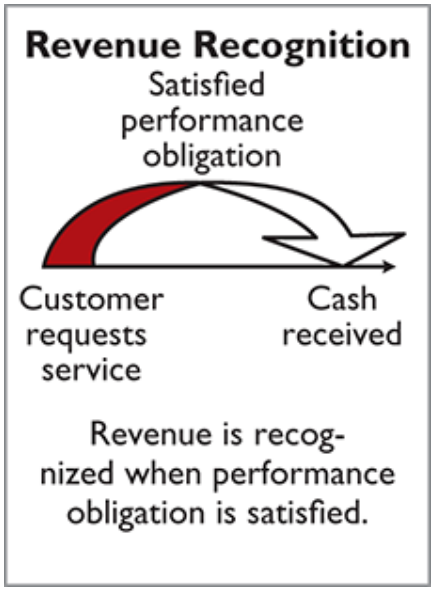
- Under the accrual basis, companies record transactions that change a company's financial statements **in the periods in which the events occur**. For example, using the accrual basis to determine net income means companies recognize revenues when they perform services (rather than when they receive cash). It also means recognizing expenses when incurred (rather than when paid).
- An alternative to the accrual basis is the cash basis. Under **cash-basis accounting**, companies record revenue at the time they receive cash. They record an expense at the time they pay out cash.

The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. For example, it fails to record revenue for a company that has performed services but has not yet received payment. As a result, the cash basis may not recognize revenue in the period that a performance obligation is satisfied.

Accrual-basis accounting is therefore in accordance with International Financial Reporting Standards (IFRS). Individuals and some small companies, however, do use cash-basis accounting. The cash basis is justified for small businesses because they often have few receivables and payables. Medium and large companies use accrual-basis accounting.

Recognizing Revenues and Expenses

It can be difficult to determine when to report revenues and expenses. The revenue recognition principle and the expense recognition principle help in this task.



Revenue Recognition Principle

When a company agrees to perform a service or sell a product to a customer, it has a performance obligation.

- The revenue recognition principle requires that companies **recognize revenue in the accounting period in which the performance obligation is satisfied.**
- A company satisfies its performance obligation by performing a service or providing a good to a customer.

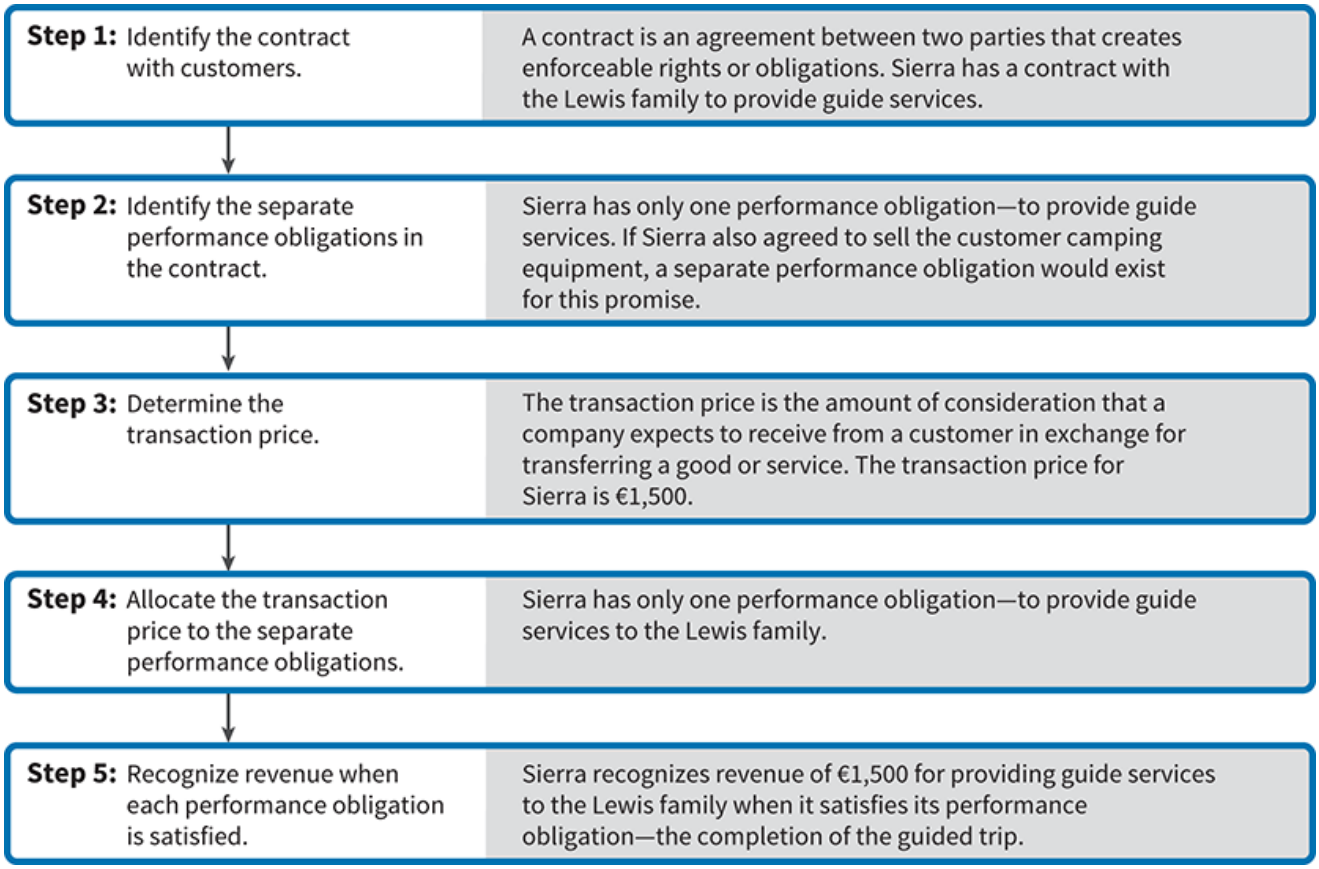
To illustrate, assume Soon Window Cleaners performs cleaning services for €100 on June 30, but customers do not pay until July 5. Under the revenue recognition principle, Soon records revenue on June 30 when it satisfies its performance obligation, which is when it performs the service, not in July when it receives the cash. At June 30, Soon would report a receivable on its balance sheet and revenue in its income statement for the service performed. The journal entries would be as follows.

June 30	Accounts Receivable		100	
	Service Revenue			100
July 5	Cash		100	
	Accounts Receivable			100

Five-Step Revenue Recognition Process—Sierra Travels Example

Revenue recognition results from a five-step process. This process can best be illustrated with an example. Assume that Sierra Travels signs a contract with the Lewis family to provide guide services for a one-week backpacking trip for €1,500. Illustration 3.1 shows the five steps that Sierra follows to recognize revenue.

ILLUSTRATION 3.1 Five steps of revenue recognition



As indicated, Step 5 is when Sierra recognizes revenue related to providing the guide services to the Lewis family. At this point, Sierra completes the trip and satisfies its performance obligation.

Expense Recognition Principle

Accountants follow a simple rule in recognizing expenses: "Let the expenses follow the revenues." Thus, expense recognition is tied to revenue recognition. In the window cleaning example, this means that Soon should report the salary expense incurred in performing the June 30 cleaning service in the same period in which it recognizes the service revenue.

- The critical issue in expense recognition is when the expense makes its contribution to revenue.
- This may or may not be the same period in which the expense is paid. If Soon does not pay the salary incurred on June 30 until July, it would report salaries payable on its June 30 statement of financial position.
- This practice of expense recognition is referred to as the **expense recognition principle**. It requires that companies recognize expenses in the period in which they make efforts (consume assets or incur liabilities) to generate revenue.
- The term matching is sometimes used in expense recognition to indicate the relationship between the effort expended and the revenue generated.

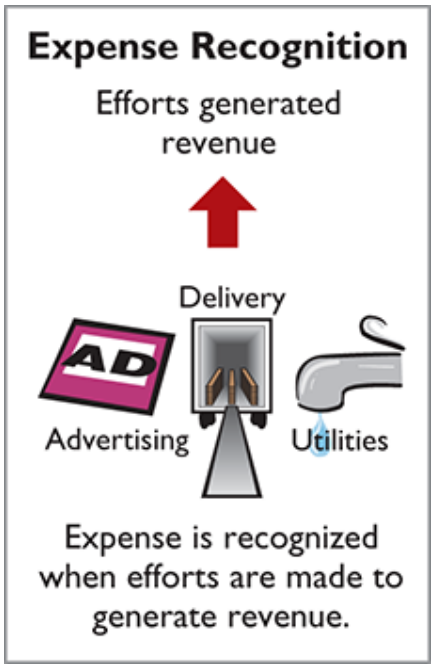
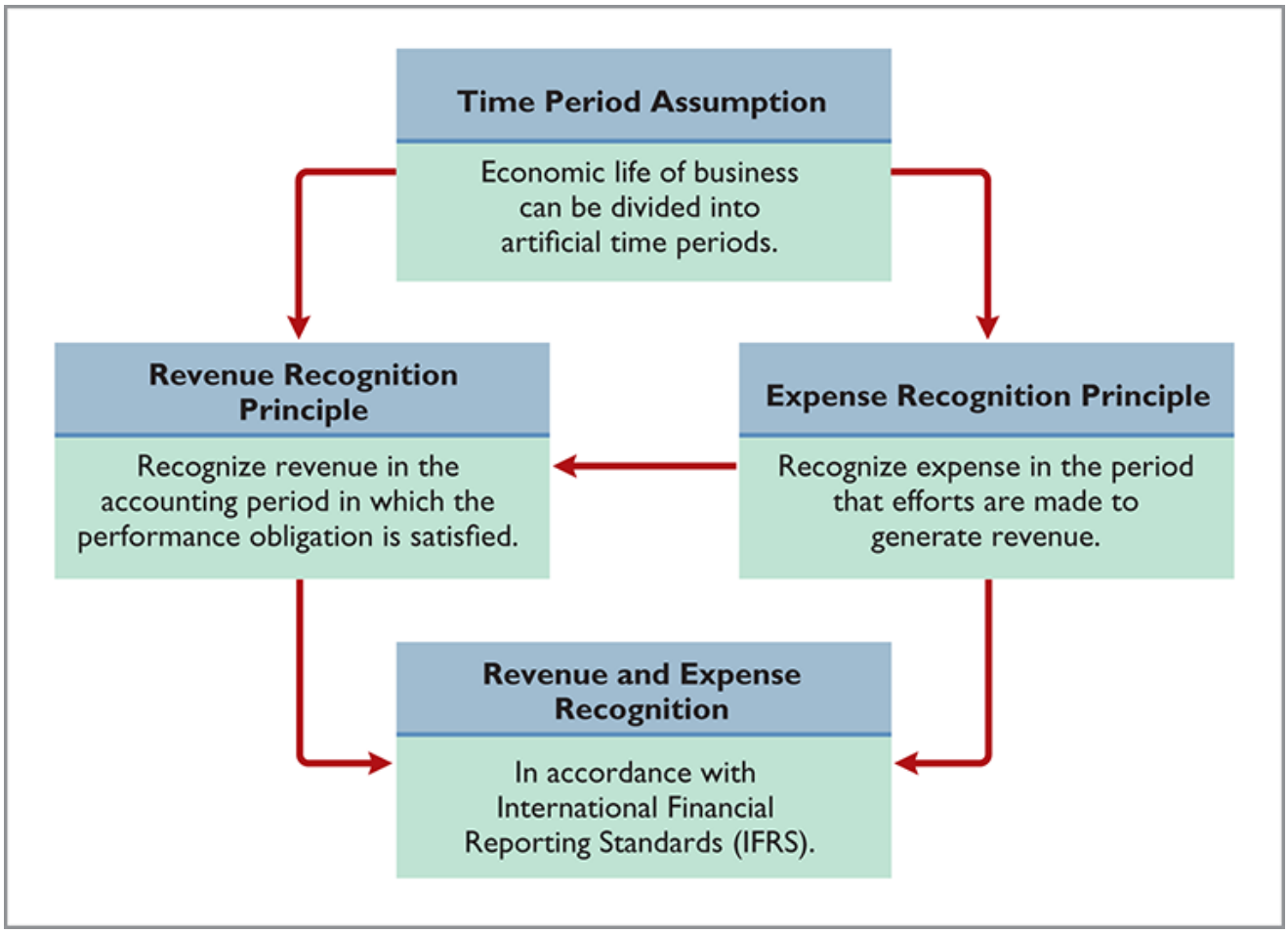


Illustration 3.2 summarizes the revenue and expense recognition principles (see Helpful Hint).

It should be noted that in cases where an expense is not connected directly to revenue, it will be reported in the period in which it was incurred. For example, interest expense is a cost of borrowing and is not associated directly with revenue. Instead, it is reported in the period where the cost was incurred. Many general and administrative expenses are treated in this manner.

ILLUSTRATION 3.2 IFRS relationships in revenue and expense recognition



HELPFUL HINT

***Recognize* means to record or report.**

Ethics Insight

Krispy Kreme

Cooking the Books?



Turnervisual/
Getty Images

Allegations of abuse of the revenue recognition principle have become all too common in recent years. For example, it was alleged that **Krispy Kreme** (USA) sometimes doubled the number of doughnuts shipped to wholesale customers at the end of a quarter to boost quarterly results. The customers shipped the unsold doughnuts back after the beginning of the next quarter for a refund.

Conversely, **China Metal Recycling Holdings (CMRH)** (CHN) was accused of a fraudulent revenue recognition practice known as round tripping. One of CMRH's suppliers transferred funds to CMHR, which then transferred the funds back to the supplier. CMHR's profits were inflated over several years by as much as 90%.

What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues?

Answer

The Need for Adjusting Entries

In order for revenues to be recorded in the period in which services are performed and for expenses to be recognized in the period in which they are incurred, companies make adjusting entries. **Adjusting entries ensure that the revenue recognition and expense recognition principles are followed**.

Adjusting entries are necessary because the **trial balance**—the first pulling together of the transaction data—may not contain up-to-date and complete data. This is true for several reasons:

1. Some events are not recorded daily because it is not efficient to do so. Examples are the use of supplies and the earning of wages by employees.
2. Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions. Examples are charges related to the use of buildings and equipment, rent, and insurance.
3. Some items may be unrecorded. An example is a utility service bill that will not be received until the next accounting period.

Adjusting entries are required every time a company prepares financial statements. The company analyzes each account in the trial balance to determine whether it is complete and up-to-date for financial statement purposes. **Every adjusting entry will include one income statement account and one statement of financial position account.**

Types of Adjusting Entries

Adjusting entries are classified as either **deferrals** or **accruals**. As **Illustration 3.3** shows, each of these classes has two subcategories.

ILLUSTRATION 3.3 Categories of adjusting entries

Deferrals:

1. **Prepaid expenses:** Expenses paid in cash before they are used or consumed.
2. **Unearned revenues:** Cash received before services are performed.

Accruals:

1. **Accrued revenues:** Revenues for services performed but not yet received in cash or recorded.
2. **Accrued expenses:** Expenses incurred but not yet paid in cash or recorded.

Subsequent sections give examples of each type of adjustment. Each example is based on the October 31 trial balance of Yazici Advertising A.Ş. from Chapter 2, reproduced in **Illustration 3.4**. Note that Retained Earnings has been added to this trial balance with a zero balance. We will explain its use later.

ILLUSTRATION 3.4 Trial balance

Yazici Advertising A.Ş.
Trial Balance
October 31, 2025

	Debit	Credit
Cash	₺15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		₺ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	₺28,700	₺28,700

We assume that Yazici uses an accounting period of one month. Thus, monthly adjusting entries are made. The entries are dated October 31.

DO IT! 1

Timing Concepts

Below is a list of concepts in the left column, with a description of the concept in the right column. There are more descriptions provided than concepts. Match the description to the concept.

1. _____ Accrual-basis accounting.
2. _____ Calendar year.
3. _____ Time period assumption.
4. _____ Expense recognition principle.

a. Monthly and quarterly time periods.

b. Efforts (expenses) should be recognized in the period in which a company uses assets or incurs liabilities to generate results (revenues).

c. Accountants divide the economic life of a business into artificial time periods.

d. Companies record revenues when they receive cash and record expenses when they pay out cash.

e. An accounting time period that starts on January 1 and ends on December 31.

f. Companies record transactions in the period in which the events occur.

ACTION PLAN

- **Review the definitions of the timing concepts in the Glossary Review section.**
- **Study carefully the revenue recognition principle, the expense recognition principle, and the time period assumption.**

Solution

Related exercise material: **BE3.1**, **DO IT! 3.1**, **E3.1**, **E3.2**, **and** **E3.3**.

3.2 Adjusting Entries for Deferrals

LEARNING OBJECTIVE 2

Prepare adjusting entries for deferrals.



To defer means to postpone or delay. **Deferrals** are expenses or revenues that are recognized at a date later than the point when cash was originally exchanged. The two types of deferrals are prepaid expenses and unearned revenues.

Prepaid Expenses

When companies record payments of expenses that will benefit more than one accounting period, they record an asset called **prepaid expenses** or **prepayments**. When expenses are prepaid, an asset account is increased (debited) to show the service or benefit that the company will receive in the future. Examples

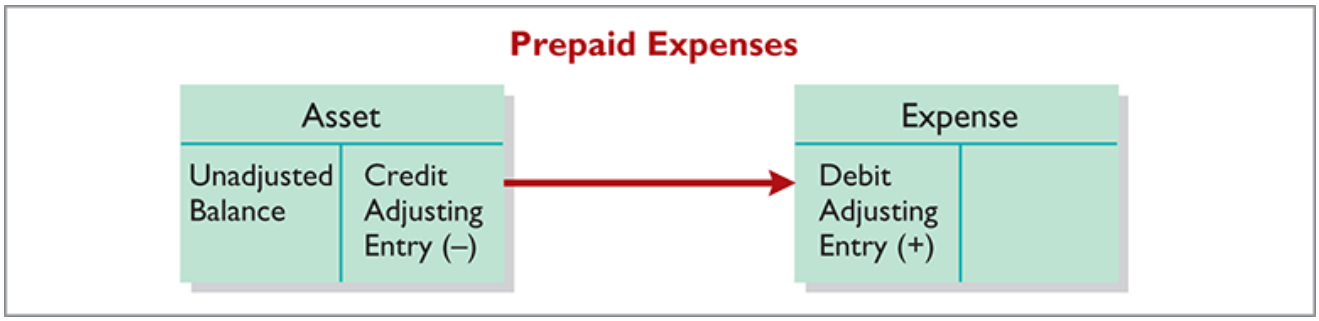
of common prepayments are insurance, supplies, advertising, and rent. In addition, companies make prepayments when they purchase buildings and equipment.

- **Prepaid expenses are costs that expire either with the passage of time** (e.g., rent and insurance) **or through use** (e.g., supplies).
- The expiration of these costs does not require daily entries, which would be impractical and unnecessary. Accordingly, companies postpone the recognition of such cost expirations until they prepare financial statements.
- At each statement date, they make adjusting entries to record the expenses applicable to the current accounting period and to show the remaining amounts in the asset accounts.

Prior to adjustment, assets are overstated and expenses are understated. Therefore, as shown in Illustration 3.5, **an adjusting entry for prepaid expenses results in an increase (a debit) to an expense account and a decrease (a credit) to an asset account**.

Let's look in more detail at some specific types of prepaid expenses, beginning with supplies.

ILLUSTRATION 3.5 Adjusting entries for prepaid expenses



Supplies

The purchase of supplies, such as paper and envelopes, results in an increase (a debit) to an asset account. During the accounting period, the company uses supplies. Rather than record supplies expense as the supplies are used, companies recognize supplies expense at the **end** of the accounting period.

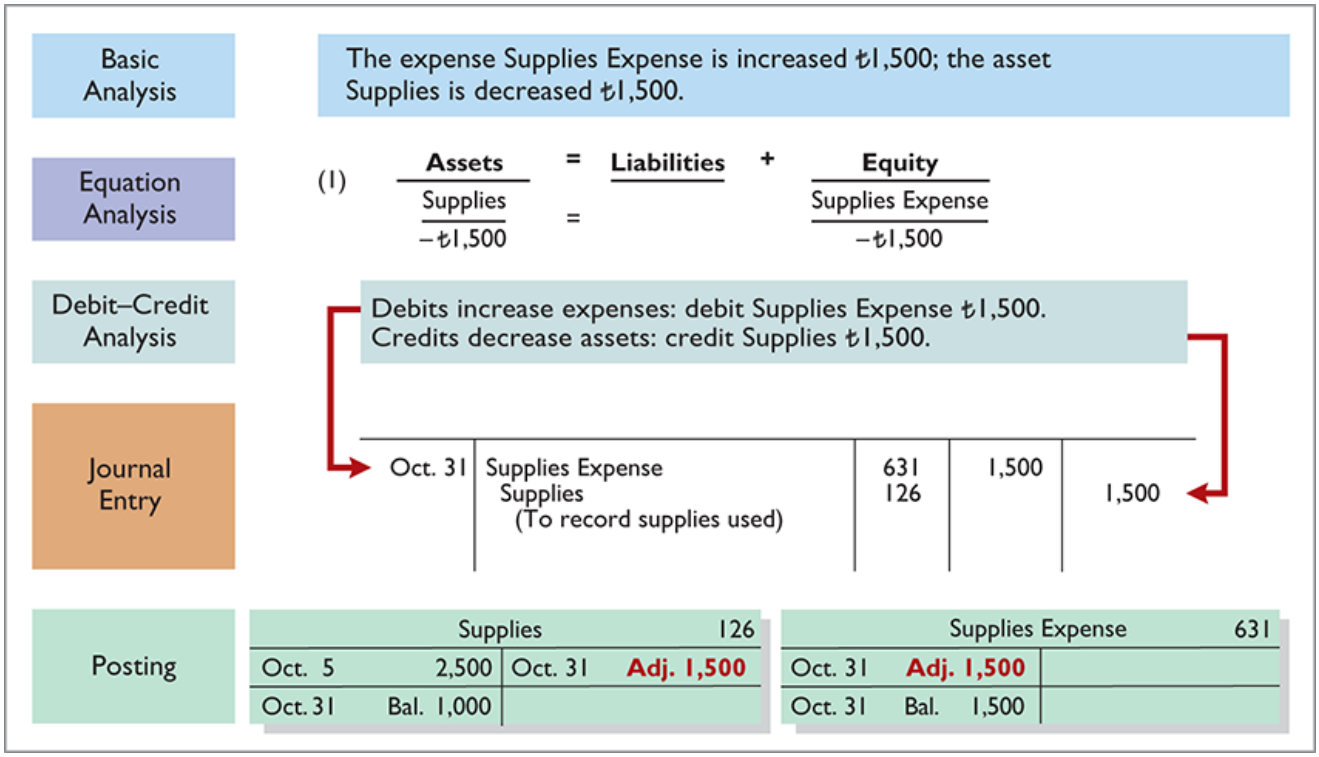
- At the end of the accounting period, the company counts the remaining supplies.
- The difference between the unadjusted balance in the Supplies (asset) account and the actual cost of supplies on hand represents the supplies used (an expense) for that period.



Recall from Chapter 2 that Yazici Advertising purchased supplies costing ₺2,500 on October 5. Yazici recorded the purchase by increasing (debiting) the asset Supplies. This account shows a balance of ₺2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that ₺1,000 of supplies are still on hand. Thus, the cost of supplies used is ₺1,500 (₺2,500 – ₺1,000). This use of supplies decreases an asset, Supplies. It also decreases equity by increasing an expense account, Supplies Expense. This is shown in Illustration 3.6. (see Helpful Hint).

> **HELPFUL HINT**
>
> **Due to their nature, adjusting entries have no effect on cash flows. As a result, we do not show the cash flow effects in these illustrations.**

ILLUSTRATION 3.6 Adjustment for supplies



After adjustment, the asset account Supplies shows a balance of ₺1,000, which is equal to the cost of supplies on hand at the statement date. In addition, Supplies Expense shows a balance of ₺1,500, which equals the cost of supplies used in October.

- If Yazici does not make the adjusting entry, October expenses are understated and net income is overstated by ₺1,500.
- Moreover, both assets and equity will be overstated by ₺1,500 on the October 31 statement of financial position.

Insurance

Companies purchase insurance to protect themselves from losses due to fire, theft, and unforeseen events. Insurance must be paid in advance, often for multiple months.

- The cost of insurance (premiums) paid in advance is recorded as an increase (debit) in the asset account Prepaid Insurance.
- At the financial statement date, companies increase (debit) Insurance Expense and decrease (credit) Prepaid Insurance for the cost of insurance that has expired during the period.

On October 4, Yazici Advertising paid ₺600 for a one-year fire insurance policy. Coverage began on October 1. Yazici recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of ₺600 in the October 31 trial balance. Insurance of ₺50 (₺600 ÷ 12) expires each month. The expiration of prepaid insurance decreases an asset, Prepaid Insurance. It also decreases equity by increasing an expense account, Insurance Expense.

As shown in Illustration 3.7, the asset Prepaid Insurance shows a balance of ₺550, which represents the unexpired cost for the remaining 11 months of coverage. At the same time, the balance in Insurance Expense equals the insurance cost that expired in October.

- If Yazici does not make this adjustment, October expenses are understated by ₺50 and net income is overstated by ₺50.
- Moreover, both assets and equity will be overstated by ₺50 on the October 31 statement of financial position.

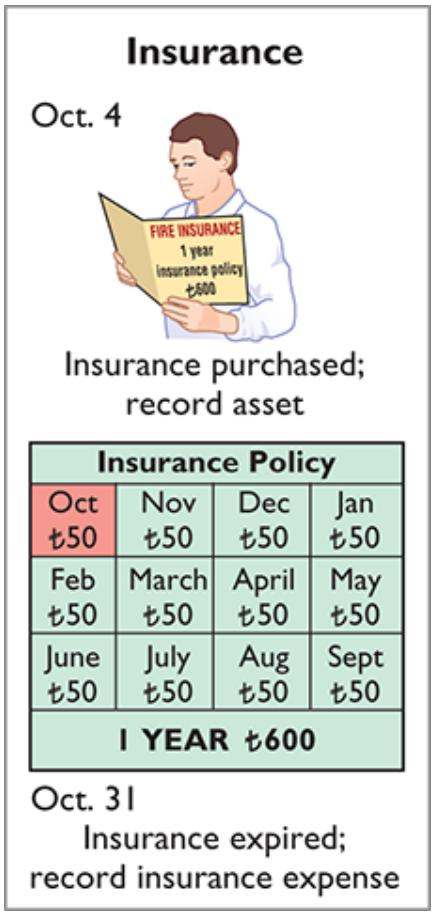


ILLUSTRATION 3.7 Adjustment for insurance

Basic Analysis

The expense Insurance Expense is increased ₺50; the asset Prepaid Insurance is decreased ₺50.

Equation Analysis

(2) Assets = Liabilities + Equity

Prepaid Insurance −₺50 = Insurance Expense −₺50

Debit–Credit Analysis

Debits increase expenses: debit Insurance Expense ₺50.
Credits decrease assets: credit Prepaid Insurance ₺50.

Journal Entry

Oct. 31	Insurance Expense	722	50	
	Prepaid Insurance	130		50
	(To record insurance expired)			

Posting

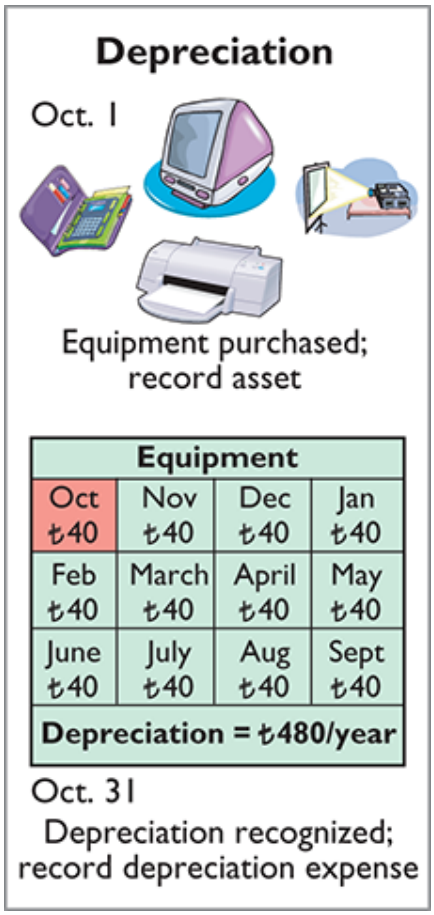
Prepaid Insurance			130
Oct. 4	600	Oct. 31	Adj. 50
Oct. 31	Bal. 550		

Insurance Expense			722
Oct. 31	Adj. 50		
Oct. 31	Bal. 50		

Depreciation

A company typically owns a variety of assets that have long lives, such as buildings, equipment, and motor vehicles. The period of service is referred to as the **useful life** of the asset. Because a building is expected to be of service for many years, it is recorded as an asset, rather than an expense, on the date it is acquired.

- As explained in Chapter 1, companies record such assets **at cost**, as required by the historical cost basis.
- To follow the expense recognition principle, companies allocate a portion of this cost as an expense during each period of the asset's useful life.
- **Depreciation** is the process of allocating the cost of an asset to expense over its useful life.



Need for Adjustment

The acquisition of long-lived assets is essentially a long-term prepayment for the use of an asset. An adjusting entry for depreciation is needed to recognize the cost that has been used (an expense) during the period and to report the unused cost (an asset) at the end of the period. It is important to understand the following.

- Depreciation is an allocation concept, not a valuation concept.
- Depreciation allocates an asset's cost to the periods in which it is used.
- Depreciation does not attempt to report the actual change in the value of the asset.

For Yazici Advertising, assume that depreciation on the equipment is ₺480 a year, or ₺40 per month. As shown in **Illustration 3.8**, rather than decrease (credit) the asset account directly, Yazici instead credits Accumulated Depreciation—Equipment.

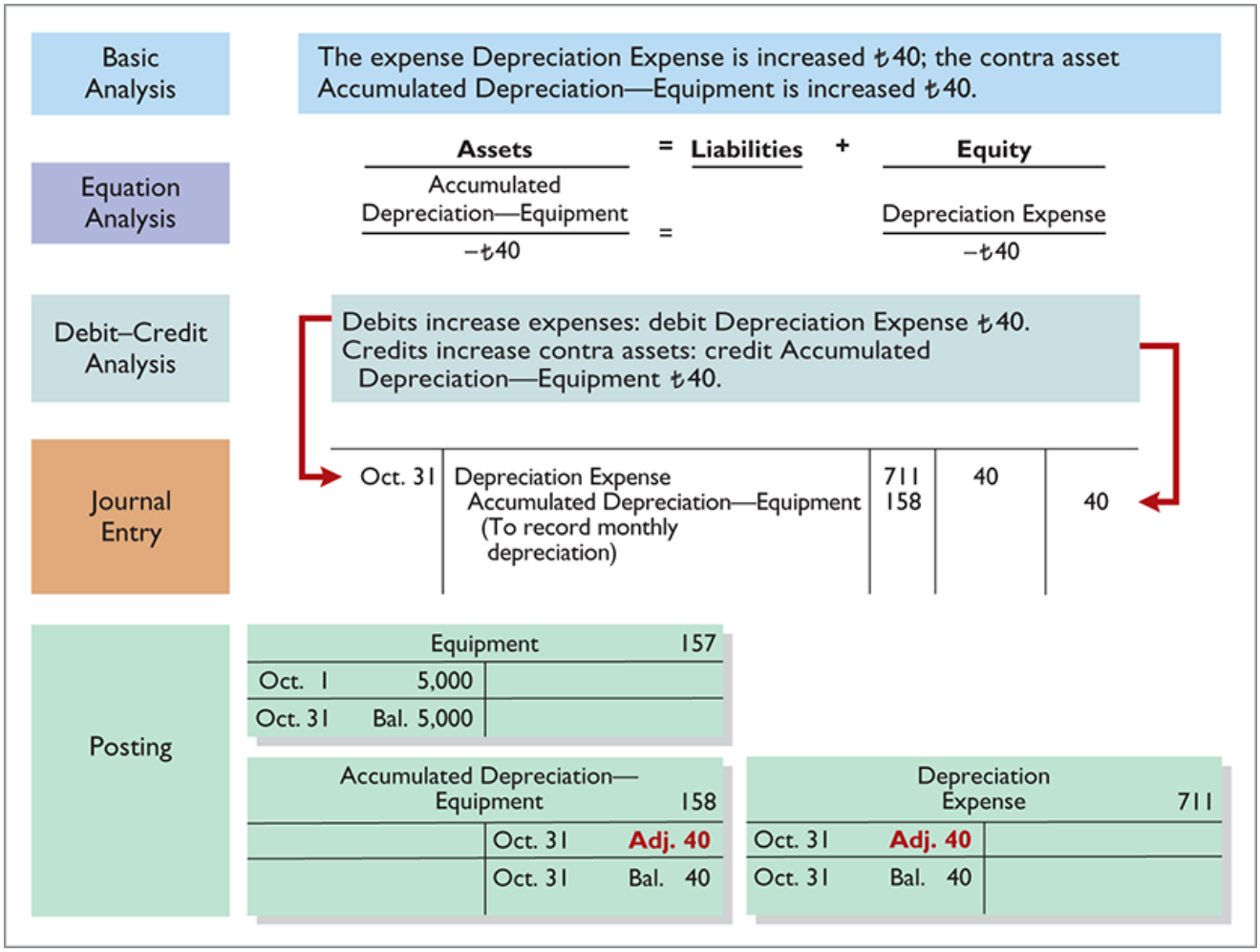
- Accumulated Depreciation is called a **contra asset account**.
- Such an account is offset against an asset account on the statement of financial position (see **Helpful Hint**). Thus, the Accumulated Depreciation—Equipment account offsets the asset Equipment.
- This account keeps track of the total amount of depreciation expense taken over the life of the asset.

HELPFUL HINT

All contra accounts have increases, decreases, and normal balances opposite to the account to which they relate.

To keep the accounting equation in balance, Yazici decreases equity by increasing an expense account, Depreciation Expense.

ILLUSTRATION 3.8 Adjustment for depreciation



The balance in the Accumulated Depreciation—Equipment account will increase ₺40 each month, and the balance in Equipment remains ₺5,000.

Statement Presentation

As indicated, Accumulated Depreciation—Equipment is a contra asset account. It is offset against Equipment on the statement of financial position. The normal balance of a contra asset account is a credit.

- A theoretical alternative to using a contra asset account would be to decrease (credit) the asset account by the amount of depreciation each period.
- But using the contra account is preferable for a simple reason: It discloses **both** the original cost of the equipment **and** the total cost that has been expensed to date.

Thus, in the statement of financial position, Yazici deducts Accumulated Depreciation—Equipment from the related asset account, as shown in Illustration 3.9.

ILLUSTRATION 3.9 Statement of financial position presentation of accumulated depreciation

Equipment	₺5,000
Less: Accumulated depreciation—equipment	40
	₺4,960

Book value is the difference between the cost of any depreciable asset and its related accumulated depreciation (see **Alternative Terminology**). In Illustration 3.9, the book value of the equipment at the statement of financial position date is ₺4,960. The book value and the current value of the asset are generally two different values. As noted earlier, **the purpose of depreciation is not valuation but a means of cost allocation**.

- Depreciation expense identifies the portion of an asset's cost that expired during the period (in this case, in October).
- The accounting equation shows that without this adjusting entry, total assets, total equity, and net income are overstated by ₺40 and depreciation expense is understated by ₺40.

> **ALTERNATIVE TERMINOLOGY**
>
> **Book value is also referred to as *carrying value*.**

Illustration 3.10 summarizes the accounting for prepaid expenses.

ILLUSTRATION 3.10 Accounting for prepaid expenses

Accounting for Prepaid Expenses

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Insurance, supplies, advertising, rent, depreciation	Prepaid expenses originally recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets or Contra Assets

Unearned Revenues

When companies receive cash before services are performed, they record a liability by increasing (crediting) a liability account called **unearned revenues**. In other words, a **company now has a performance obligation** (liability) to transfer a service to one of its customers. Items like rent, magazine subscriptions, and customer deposits for future service may result in unearned revenues. Airlines such as **Cathay Pacific** (HKG) and **Garuda Indonesia** (IDN), for instance, treat receipts from the sale of tickets as unearned revenue until the flight service is provided.

- Unearned revenues are the opposite of prepaid expenses.
- Indeed, unearned revenue on the books of one company is likely to be a prepaid expense on the books of the company that has made the advance payment.



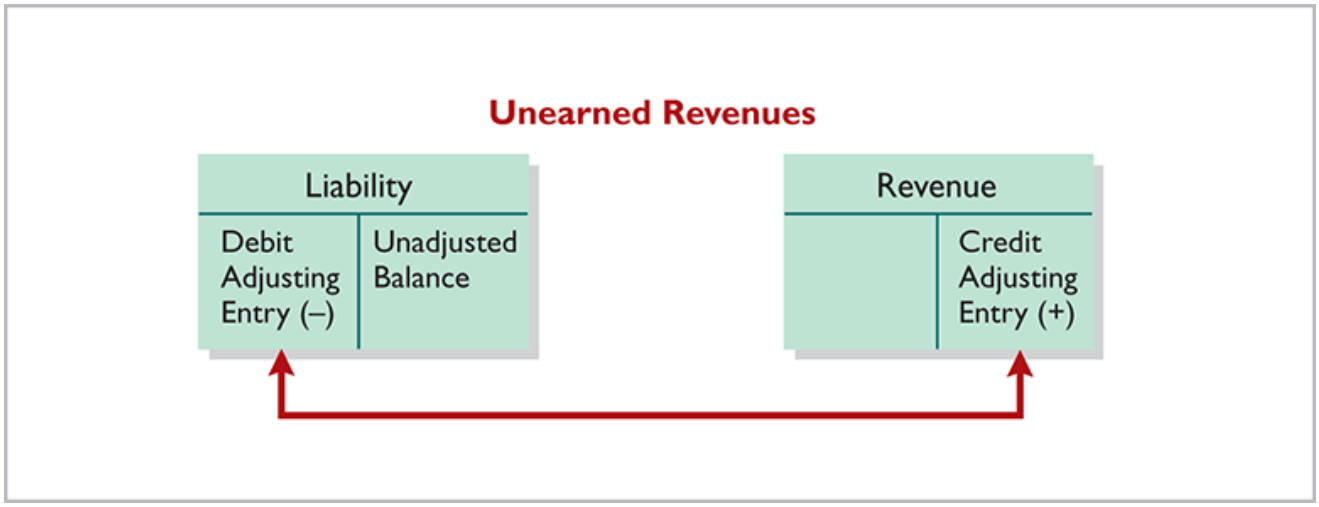
For example, if identical accounting periods are assumed, a landlord will have unearned rent revenue when a tenant has prepaid rent.

When a company receives payment for services to be performed in a future accounting period, it increases (credits) an unearned revenue (a liability) account to recognize the liability that exists. The company subsequently recognizes revenues when it performs the service.

During the accounting period, it is not practical to make daily entries as the company performs services. Instead, the company delays recognition of revenue until the adjustment process.

- The company then makes an adjusting entry to record the revenue for services performed during the period and to show the liability that remains at the end of the accounting period.
- Prior to adjustment, liabilities are overstated and revenues are understated. Therefore, the adjusting entry for unearned revenues results in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account (see **Illustration 3.11**).

ILLUSTRATION 3.11 Adjusting entries for unearned revenues



Yazici Advertising received ₺1,200 on October 2 from R. Knox for advertising services expected to be completed by December 31. Yazici credited the payment to Unearned Service Revenue. This liability account shows a balance of ₺1,200 in the October 31 trial balance. From an evaluation of the services Yazici performed for Knox during October, the company determines that it should recognize ₺400 of revenue in October. The liability (Unearned Service Revenue) is therefore decreased, and equity (Service Revenue) is increased.

As shown in Illustration 3.12, the liability Unearned Service Revenue now shows a balance of ₺800. That amount represents the remaining advertising services Yazici is obligated to perform in the future. At the same time, Service Revenue shows total revenue recognized in October of ₺10,400.

- Without this adjustment, revenues and net income are understated by ₺400 in the income statement.
- Moreover, liabilities will be overstated and equity will be understated by ₺400 on the October 31 statement of financial position.

ILLUSTRATION 3.12 Service revenue accounts after adjustment

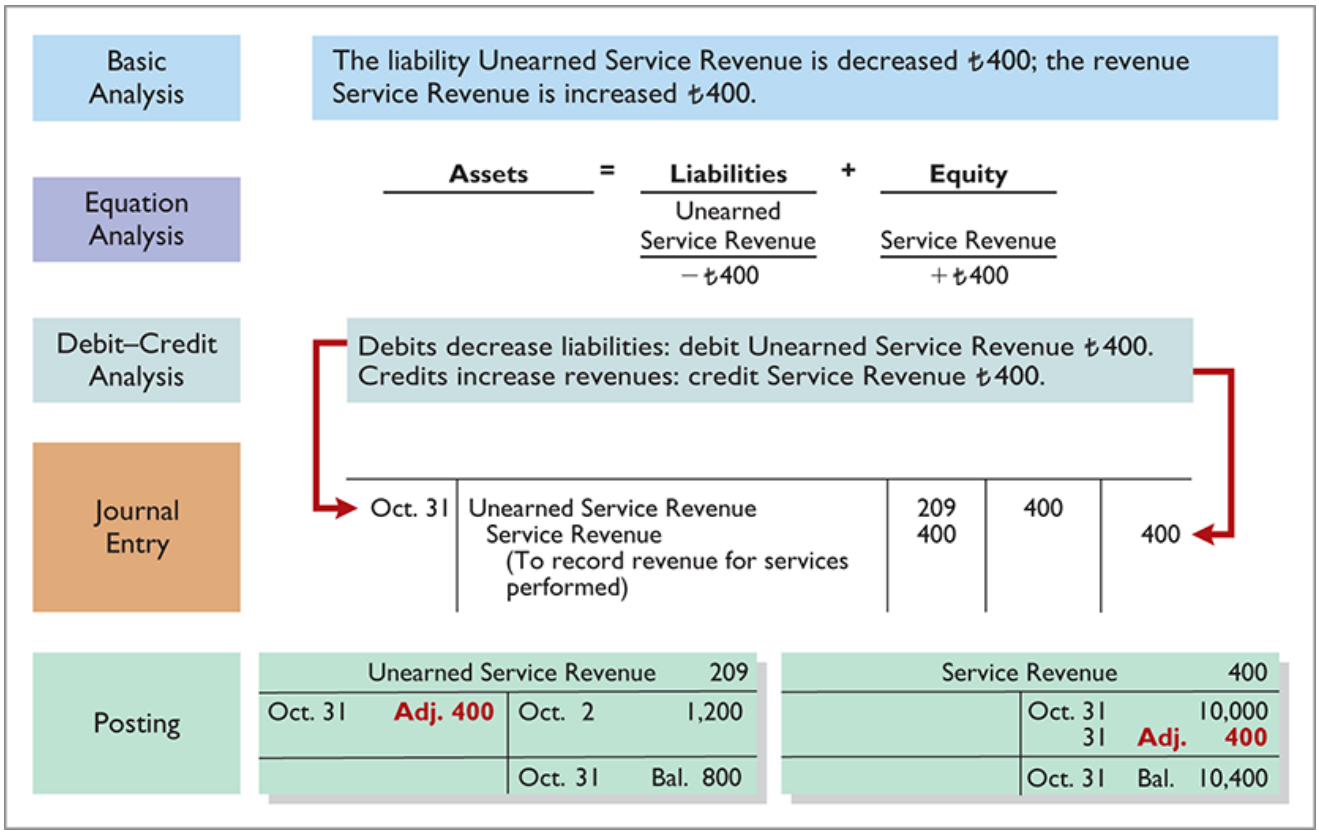


Illustration 3.13 summarizes the accounting for unearned revenues.

ILLUSTRATION 3.13 Accounting for unearned revenues

Accounting for Unearned Revenues

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Rent, magazine subscriptions, customer deposits for future service	Unearned revenues recorded in liability accounts are now recognized as revenue for services performed.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues

Accounting Across the Organization

Marks & Spencer plc

Turning Gift Cards into Revenue



REUTERS/
Alamy Images

Those of you who are marketing majors (and even most of you who are not) know that gift cards are among the hottest marketing tools in merchandising today. Customers at stores such as **Marks & Spencer plc** (GBR) purchase gift cards and give them to someone for later use.

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is exercised? How should expired gift cards be accounted for?

Suppose that Robert Valois purchases a €100 gift card at Carrefour (FRA) on December 24, 2024, and gives it to his wife, Marie Valois, on December 25, 2024. On January 3, 2025, Marie uses the card to purchase €100 worth of gourmet cheeses. When do you think Carrefour should recognize revenue and why?

Answer

DO IT! 2

Adjusting Entries for Deferrals

The ledger of Hammond Deliveries, on March 31, 2025, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	€ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		€5,000
Unearned Service Revenue		9,200

An analysis of the accounts shows the following.

1. Insurance expires at the rate of €100 per month.
2. Supplies on hand total €800.
3. The equipment depreciates €200 a month.
4. During March, services were performed for €4,000 of the unearned service revenue.

Prepare the adjusting entries for the month of March.

ACTION PLAN

- **Make adjusting entries at the end of the period for revenues recognized and expenses incurred in the period.**
- **Don't forget to make adjusting entries for deferrals. Failure to adjust for deferrals leads to overstatement of the asset or liability and understatement of the related expense or revenue.**

Solution

Related exercise material: BE3.4, BE3.5, BE3.7, BE3.8, DO IT! 3.2, E3.8, E3.9, and E3.10.

3.3 Adjusting Entries for Accruals

LEARNING OBJECTIVE 3

Prepare adjusting entries for accruals.



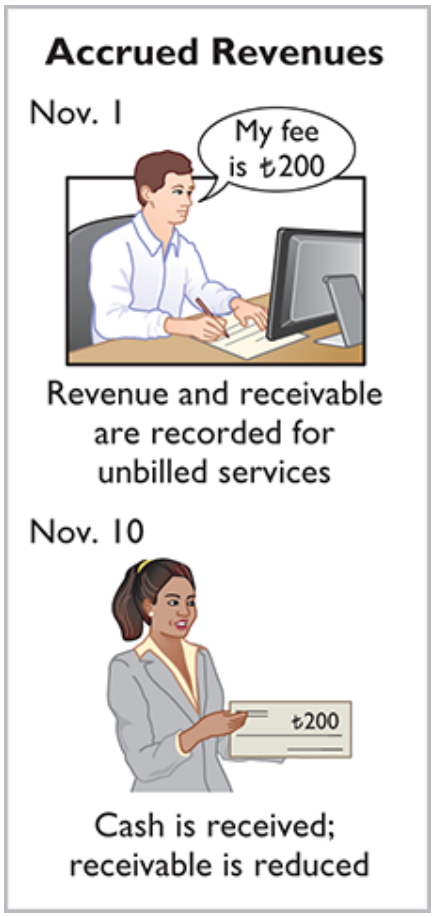
The second category of adjusting entries is **accruals**. Prior to an accrual adjustment, the revenue account (and the related asset account) or the expense account (and the related liability account) are understated. Thus, the adjusting entry for accruals will **increase both a statement of financial position and an income statement account**.

Accrued Revenues

Revenues for services performed but not yet recorded at the statement date are accrued revenues. Accrued revenues may accumulate (accrue) with the passing of time, as in the case of interest revenue. These are unrecorded because the earning of interest does not involve daily transactions. Companies do

not record interest revenue on a daily basis because it is often impractical to do so. Accrued revenues also may result from services that have been performed but not yet billed nor collected, as in the case of commissions and fees. These may be unrecorded because only a portion of the total service has been performed and the clients will not be billed until the service has been completed.

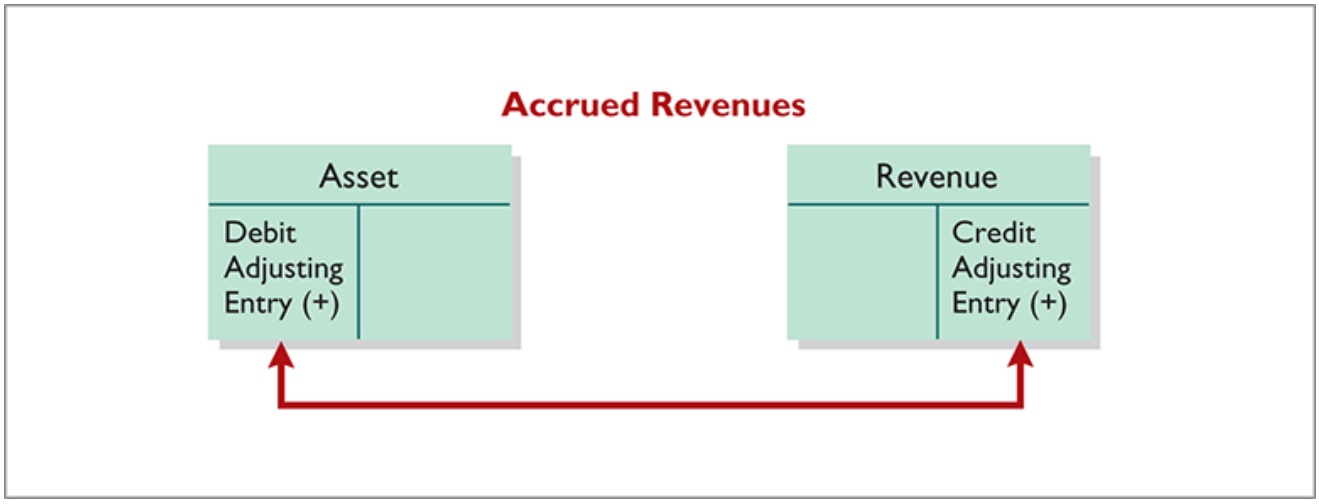
- An adjusting entry records the receivable that exists at the statement of financial position date and the revenue for the services performed during the period.
- Prior to adjustment, both assets and revenues are understated.



As shown in Illustration 3.14, an adjusting entry for accrued revenues results in an increase (a debit) to an asset account and an increase (a credit) to a revenue account (see Helpful Hint).

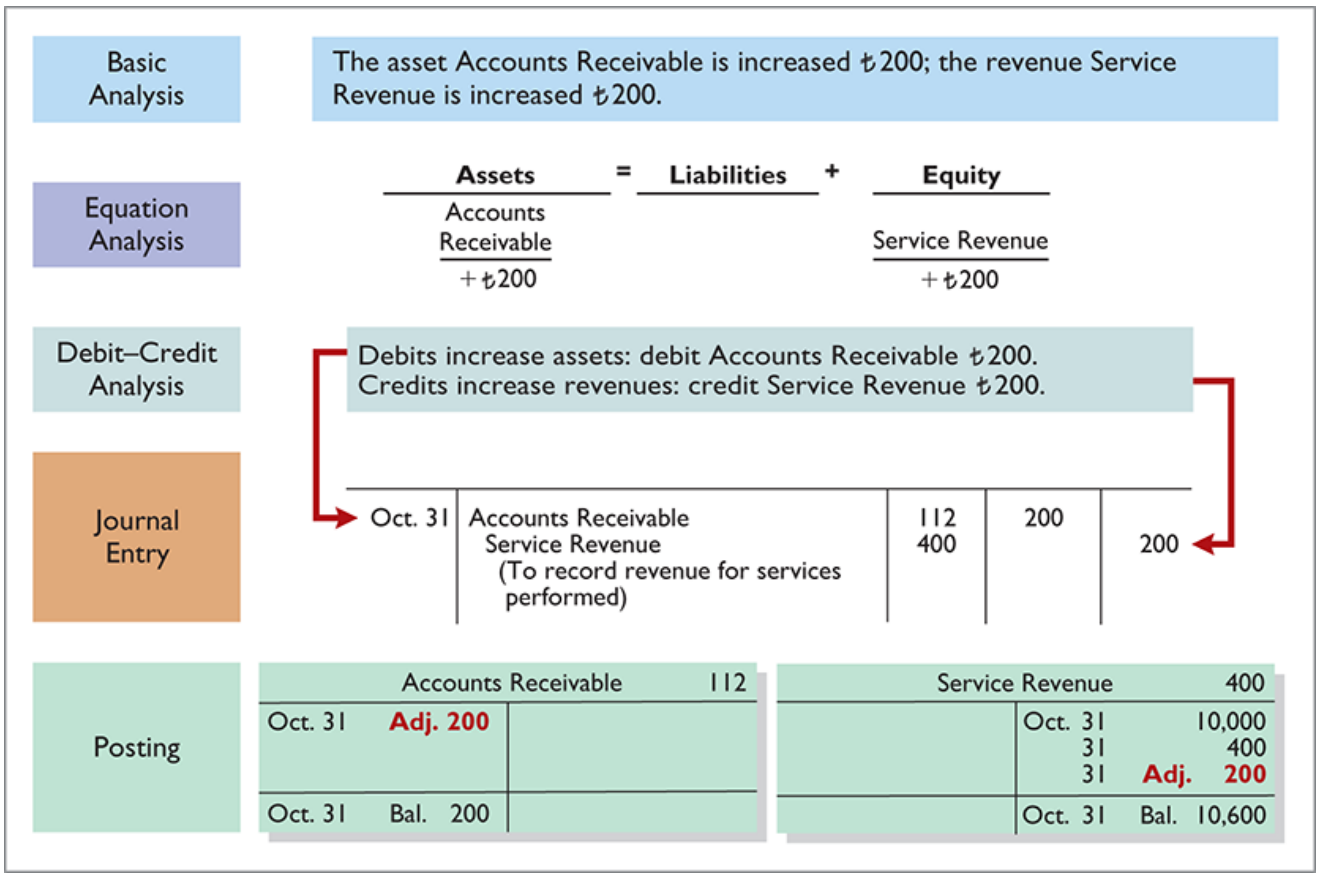
> **HELPFUL HINT**
>
> **For accruals, there may have been no prior entry, and the accounts requiring adjustment may both have zero balances prior to adjustment.**

ILLUSTRATION 3.14 Adjusting entries for accrued revenues



In October, Yazici Advertising performed services worth ₺200 that were not billed to clients on or before October 31. Because these services were not billed, they were not recorded. The accrual of unrecorded service revenue increases an asset account, Accounts Receivable. It also increases equity by increasing a revenue account, Service Revenue, as shown in Illustration 3.15.

ILLUSTRATION 3.15 Adjustment for accrued revenue

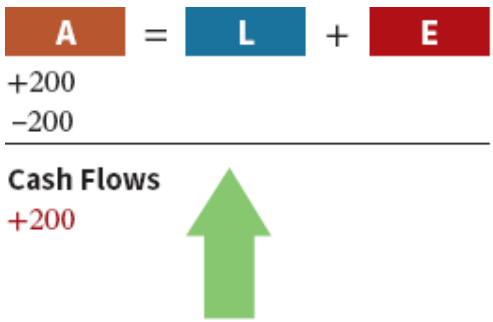


The asset Accounts Receivable shows that clients owe Yazici ₺200 at the statement of financial position date. The balance of ₺10,600 in Service Revenue represents the total revenue for services performed by Yazici during the month (₺10,000 + ₺400 + ₺200).

- Without the adjusting entry, assets and equity on the statement of financial position are understated.
- Moreover, revenues and net income on the income statement are understated.

On November 10, Yazici receives cash of ₺200 for the services performed in October and makes the following entry.

Nov. 10	Cash	200	
	Accounts Receivable		200
	(To record cash collected on account)		



Equation analyses *summarize the effects of transactions on the three elements of the accounting equation, as well as the effect on cash flows.*

The company records the collection of the receivables by a debit (increase) to Cash and a credit (decrease) to Accounts Receivable.

Illustration 3.16 summarizes the accounting for accrued revenues.

ILLUSTRATION 3.16 Accounting for accrued revenues

Accounting for Accrued Revenues

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, services	Services performed but not yet received in cash or recorded.	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues

Accrued Expenses

Expenses incurred but not yet paid or recorded at the statement date are called **accrued expenses**. Interest, taxes, and salaries are common examples of accrued expenses.

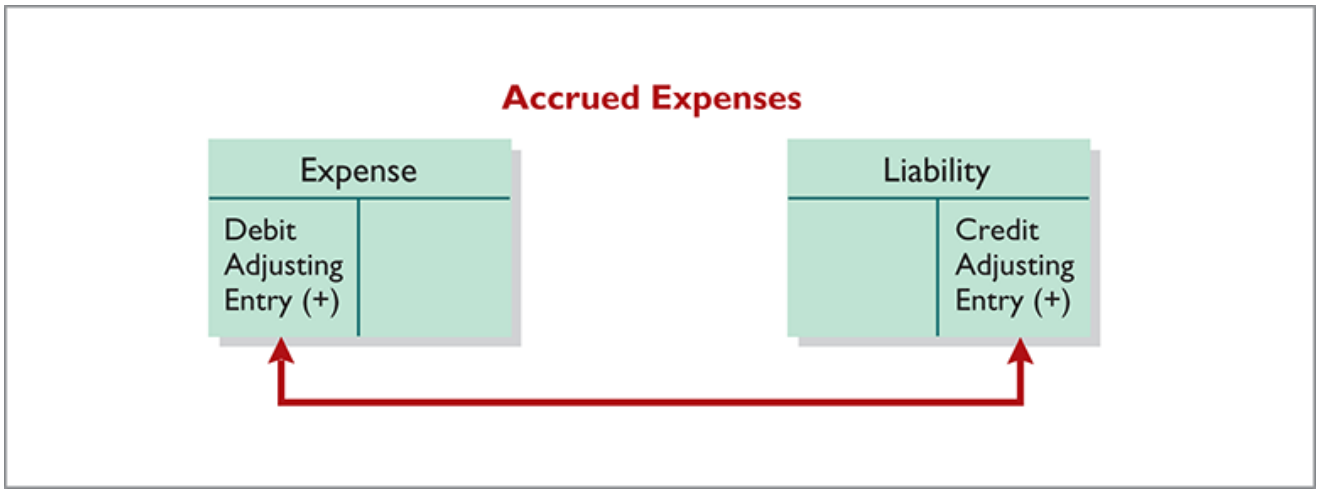
- Companies make adjustments for accrued expenses to record the obligations that exist at the statement of financial position date and to recognize the expenses that apply to the current accounting period (see Ethics Note).
- Prior to adjustment, both liabilities and expenses are understated.

ETHICS NOTE

A report released by Fannie Mae's (USA) board of directors stated that improper adjusting entries at the mortgage-finance company resulted in delayed recognition of expenses caused by interest rate changes. The motivation for such accounting apparently was the desire to hit earnings estimates.

Therefore, as Illustration 3.17 shows, an adjusting entry for accrued expenses results in an increase (a debit) to an expense account and an increase (a credit) to a liability account.

ILLUSTRATION 3.17 Adjusting entries for accrued expenses



Let's look in more detail at some specific types of accrued expenses, beginning with accrued interest.

Accrued Interest

Yazici Advertising signed a three-month note payable in the amount of ₺5,000 on October 1. The note requires Yazici to pay interest at an annual rate of 12%.

The amount of the interest recorded is determined by three factors.

1. The face value of the note.
2. The interest rate, which is always expressed as an annual rate.
3. The length of time the note is outstanding.

For Yazici, the total interest due on the ₺5,000 note at its maturity date three months in the future is ₺150 (₺5,000 × 12% × $\frac{3}{12}$), or ₺50 for one month. Illustration 3.18 shows the formula for computing interest and its application to Yazici for the month of October (see Helpful Hint).

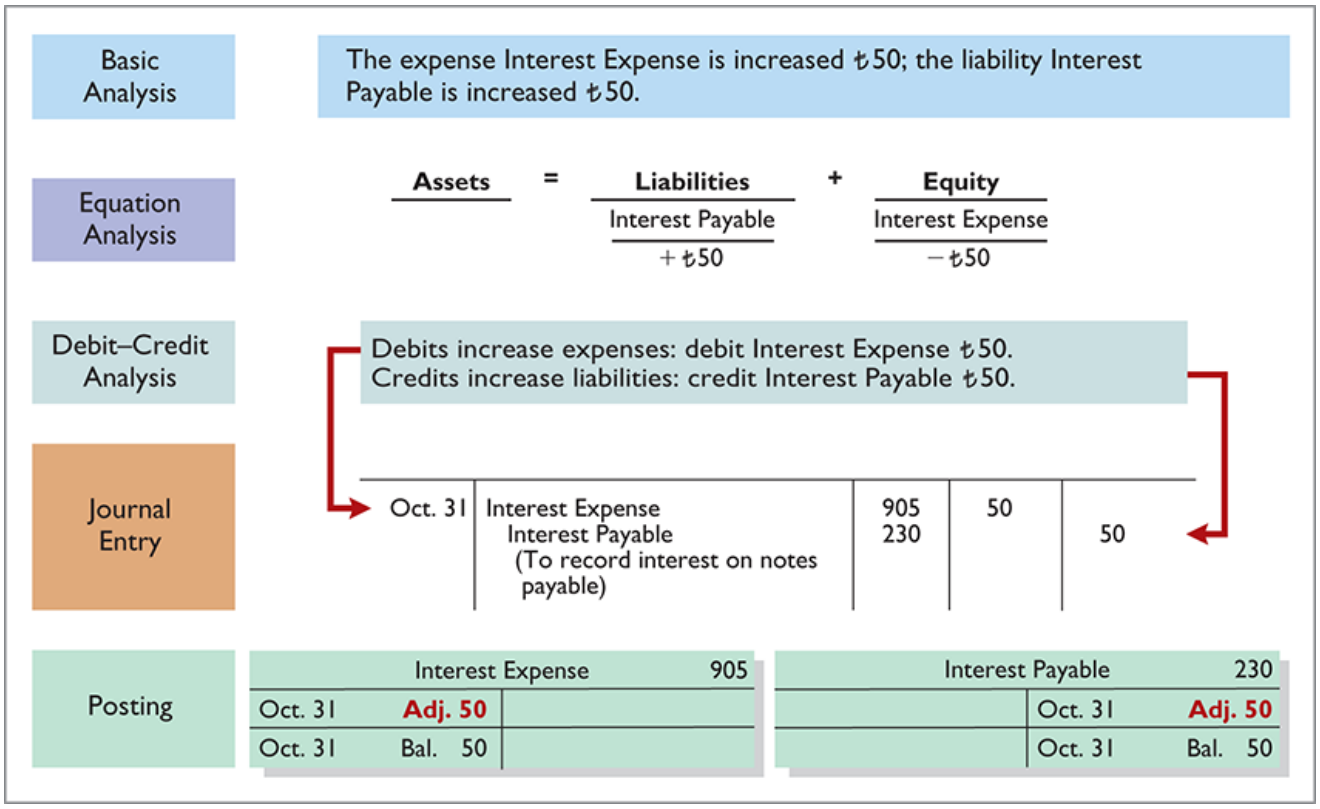
> **HELPFUL HINT**
>
> **In computing interest, we express the time period as a fraction of a year.**

ILLUSTRATION 3.18 Formula for computing interest

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
₺5,000	×	12%	×	$\frac{1}{12}$	=	₺50

As Illustration 3.19 shows, the accrual of interest at October 31 increases a liability account, Interest Payable. It also decreases equity by increasing an expense account, Interest Expense.

ILLUSTRATION 3.19 Adjustment for accrued interest



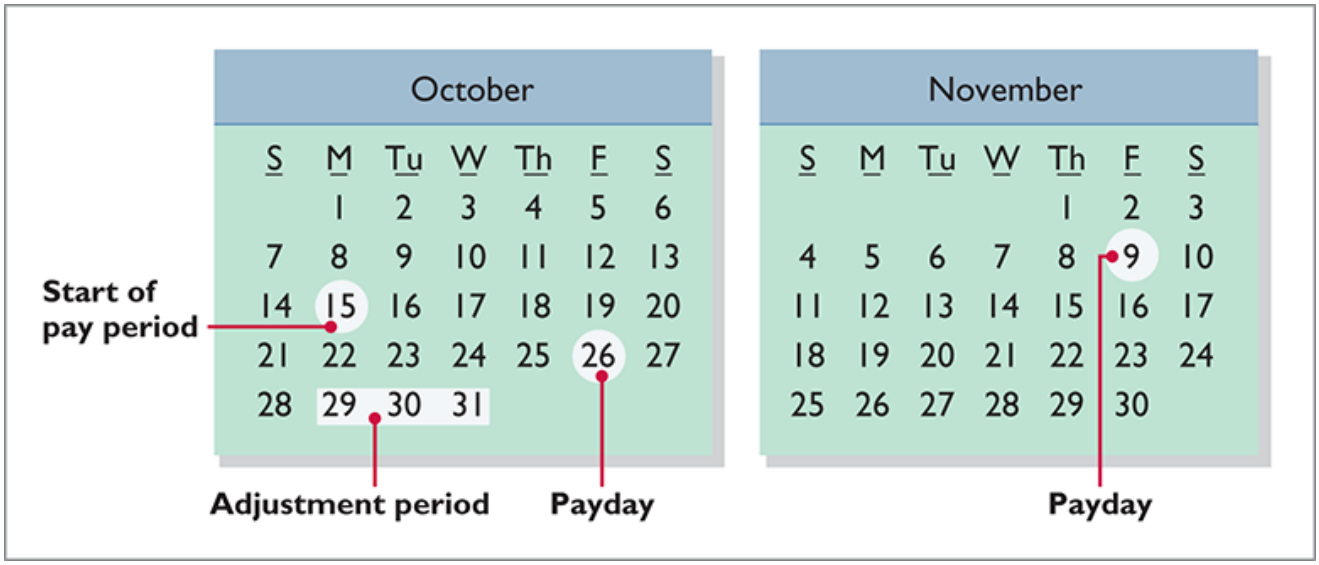
Interest Expense shows the interest charges for the month of October. Interest Payable shows the amount of interest the company owes at the statement date. Yazici will not pay the interest until the note comes due at the end of three months. Companies use the Interest Payable account, instead of crediting Notes Payable, to disclose the two different types of obligations—interest and principal—in the accounts and statements.

- Without this adjusting entry, liabilities and interest expense are understated.
- Moreover, net income and equity are overstated.

Accrued Salaries and Wages

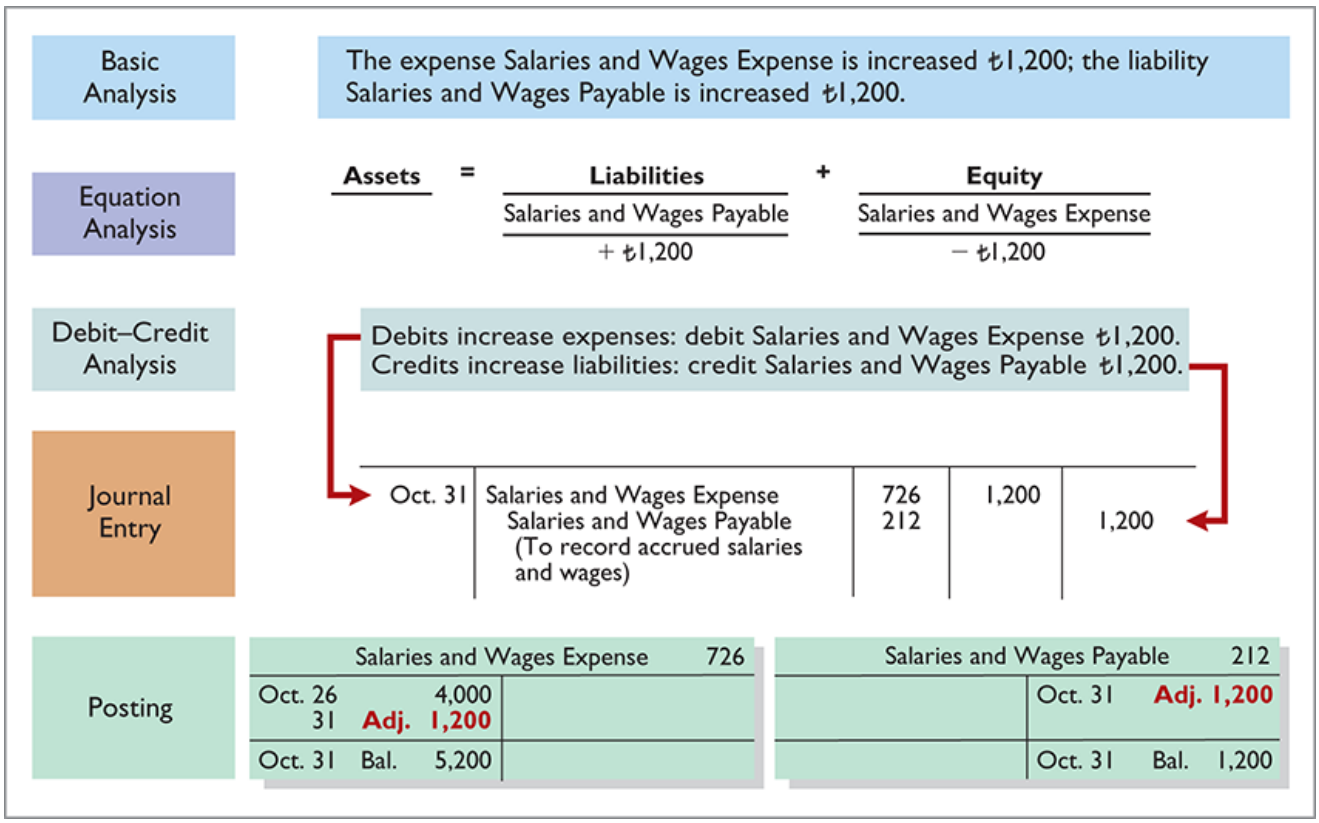
Companies pay for some types of expenses, such as employee salaries and wages, after the services have been performed. Yazici Advertising paid salaries and wages on October 26 for its employees' first two weeks of work. The next payment of salaries will not occur until November 9. As Illustration 3.20 shows, three working days remain in October (October 29–31).

ILLUSTRATION 3.20 **Calendar showing Yazici's pay periods**



At October 31, the salaries and wages for these three days represent an accrued expense and a related liability to Yazici. The employees receive total salaries and wages of ₺2,000 for a five-day work week, or ₺400 per day. Thus, accrued salaries and wages at October 31 are ₺1,200 (₺400 × 3). This accrual increases a liability, Salaries and Wages Payable. It also decreases equity by increasing an expense account, Salaries and Wages Expense, as shown in **Illustration 3.21**.

ILLUSTRATION 3.21 **Adjustment for accrued salaries and wages**

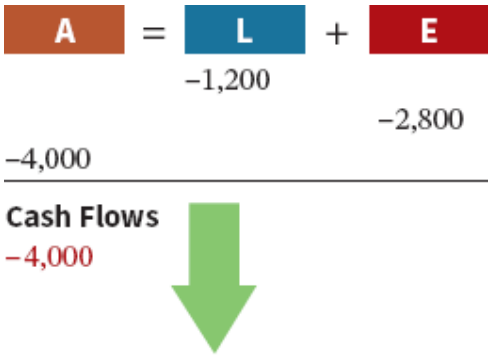


After this adjustment, the balance in Salaries and Wages Expense of ₺5,200 (13 days × ₺400) is the actual salary and wages expense for October. The balance in Salaries and Wages Payable of ₺1,200 is the amount of the liability for salaries and wages Yazici owes as of October 31.

- Without the ₺1,200 adjustment for salaries and wages, Yazici's expenses are understated ₺1,200.
- Moreover, its liabilities are understated ₺1,200.

Yazici pays salaries and wages every two weeks. Consequently, the next payday is November 9, when the company will again pay total salaries and wages of ₺4,000. The payment consists of ₺1,200 of salaries and wages payable at October 31 plus ₺2,800 of salaries and wages expense for November (7 working days, as shown in the November calendar × ₺400). Therefore, Yazici makes the following entry on November 9.

Nov. 9	Salaries and Wages Payable	1,200	
	Salaries and Wages Expense	2,800	
	Cash		4,000
	(To record November 9 payroll)		



This entry eliminates the liability for Salaries and Wages Payable that Yazici recorded in the October 31 adjusting entry, and it records the proper amount of Salaries and Wages Expense for the period between November 1 and November 9.

Illustration 3.22 summarizes the accounting for accrued expenses.

ILLUSTRATION 3.22 Accounting for accrued expenses

Accounting for Accrued Expenses

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, salaries	Expenses have been incurred but not yet paid in cash or recorded.	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities

Environmental, Social, and Governance Insight

Got Junk?



njgphoto/Getty Images

While the digital revolution has changed the way we work, play, and communicate, it has a downside. Every new mobile phone, laptop, and TV that we purchase is often replacing a previous mobile phone, laptop, or TV. Current estimates are that we generate around 40 million tons of electronic waste every year, worldwide. That's like throwing away 800 laptops every second. And current estimates are that only 12.5% of our electronic waste is currently being recycled.

Each of these old phones, computers, and TVs is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.

What accounting issue might this cause for companies?

Answer

Summary of Basic Relationships

Illustration 3.23 summarizes the four basic types of adjusting entries. Take some time to study and analyze the adjusting entries. Be sure to note that **each adjusting entry affects one statement of financial position account and one income statement account**.

ILLUSTRATION 3.23 Summary of adjusting entries

Type of Adjustment	Accounts Before Adjustment	Adjusting Entry
Prepaid expenses	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets or Contra Assets
Unearned revenues	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities

Illustrations 3.24 and 3.25 show the journalizing and posting of adjusting entries for Yazici Advertising on October 31. The ledger identifies all adjustments by the reference J2 because they have been recorded on page 2 of the general journal. The company may insert a center caption "Adjusting Entries" between the last transaction entry and the first adjusting entry in the journal. When you review the general ledger in Illustration 3.25, note that the entries highlighted in red are the adjustments.

ILLUSTRATION 3.24 General journal showing adjusting entries

GENERAL JOURNAL J2

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025	Adjusting Entries			
Oct. 31	Supplies Expense	631	1,500	
	Supplies	126		1,500
	(To record supplies used)			
31	Insurance Expense	722	50	
	Prepaid Insurance	130		50
	(To record insurance expired)			
31	Depreciation Expense	711	40	
	Accumulated Depreciation—Equipment	158		40
	(To record monthly depreciation)			
31	Unearned Service Revenue	209	400	
	Service Revenue	400		400
	(To record revenue for services performed)			
31	Accounts Receivable	112	200	
	Service Revenue	400		200
	(To record revenue for services performed)			
31	Interest Expense	905	50	
	Interest Payable	230		50
	(To record interest on notes payable)			
31	Salaries and Wages Expense	726	1,200	
	Salaries and Wages Payable	212		1,200
	(To record accrued salaries and wages)			

(1) Adjusting entries should not involve debits or credits to Cash.

(2) Evaluate whether the adjustment makes sense. For example, an adjustment to recognize supplies used should increase Supplies Expense.

(3) Double-check all computations.

(4) Each adjusting entry affects one statement of financial position account and one income statement account.

ILLUSTRATION 3.25 General ledger after adjustment

GENERAL LEDGER

Cash **No. 101**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	1		J1	10,000		10,000
	2		J1	1,200		11,200
	3		J1		900	10,300
	4		J1		600	9,700
	20		J1		500	9,200
	26		J1		4,000	5,200
	31		J1	10,000		15,200

Accounts Receivable **No. 112**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**	**200**		**200**

Supplies **No. 126**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	5		J1	2,500		2,500
	31	**Adj. entry**	**J2**		**1,500**	**1,000**

Prepaid Insurance **No. 130**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	4		J1	600		600
	31	**Adj. entry**	**J2**		**50**	**550**

Equipment **No. 157**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	1		J1	5,000		5,000

Accumulated Depreciation—Equipment **No. 158**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**		**40**	**40**

Notes Payable **No. 200**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						

Cash **No. 101**

Oct.	1		J1		5,000	5,000

Accounts Payable **No. 201**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	5		J1		2,500	2,500

Unearned Service Revenue **No. 209**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	2		J1		1,200	1,200
	31	**Adj. entry**	**J2**	**400**		**800**

Salaries and Wages Payable **No. 212**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**		**1,200**	**1,200**

Interest Payable **No. 230**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**		**50**	**50**

Share Capital—Ordinary **No. 311**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	1		J1		10,000	10,000

Retained Earnings **No. 320**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						

Dividends **No. 332**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	20		J1	500		500

Service Revenue **No. 400**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						

Cash **No. 101**

Oct.	31		J1		10,000	10,000
	31	**Adj. entry**	**J2**		**400**	**10,400**
	31	**Adj. entry**	**J2**		**200**	**10,600**

Supplies Expense **No. 631**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**	**1,500**		**1,500**

Depreciation Expense **No. 711**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**	**40**		**40**

Insurance Expense **No. 722**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**	**50**		**50**

Salaries and Wages Expense **No. 726**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	26		J1	4,000		4,000
	31	**Adj. entry**	**J2**	**1,200**		**5,200**

Rent Expense **No. 729**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	3		J1	900		900

Interest Expense **No. 905**

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
Oct.	**31**	**Adj. entry**	**J2**	**50**		**50**

DO IT! 3

Adjusting Entries for Accruals

Mahindra Computer Services began operations on August 1, 2025. At the end of August 2025, management prepares monthly financial statements. The following information relates to August (amounts in thousands).

1. At August 31, the company owed its employees ₹800 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed ₹30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
3. Revenue for services performed but unrecorded for August totaled ₹1,100.

Prepare the adjusting entries needed at August 31, 2025.

ACTION PLAN

- **Make adjusting entries at the end of the period to recognize revenues for services performed and for expenses incurred.**
- **Don't forget to make adjusting entries for accruals. Adjusting entries for accruals will increase both a statement of financial position and an income statement account.**

Solution

Related exercise material: **BE3.9, DO IT! 3.3, E3.5, E3.6, E3.7, E3.8, E3.9, and E3.10.**

3.4 Adjusted Trial Balance and Financial Statements

LEARNING OBJECTIVE 4

Describe the nature and purpose of an adjusted trial balance.



After a company has journalized and posted all adjusting entries, it prepares another trial balance from the ledger accounts. This trial balance is called an **adjusted trial balance**.

- The adjusted trial balance shows the balances of all accounts, including those adjusted, at the end of the accounting period.
- The purpose of an adjusted trial balance is to **prove the equality** of the total debit balances and the total credit balances in the ledger after all adjustments.
- Because the accounts contain all data needed for financial statements, the adjusted trial balance is the **primary basis for the preparation of financial statements**.

Preparing the Adjusted Trial Balance

Illustration 3.26 presents the adjusted trial balance for Yazici Advertising A.Ş. prepared from the ledger accounts in Illustration 3.25. The amounts affected by the adjusting entries are highlighted in red. Compare these amounts to those in the unadjusted trial balance in Illustration 3.4. In this comparison, you will see that there are more accounts in the adjusted trial balance as a result of the adjusting entries made at the end of the month.

ILLUSTRATION 3.26 Adjusted trial balance

Yazici Advertising A.Ş.
Adjusted Trial Balance
October 31, 2025

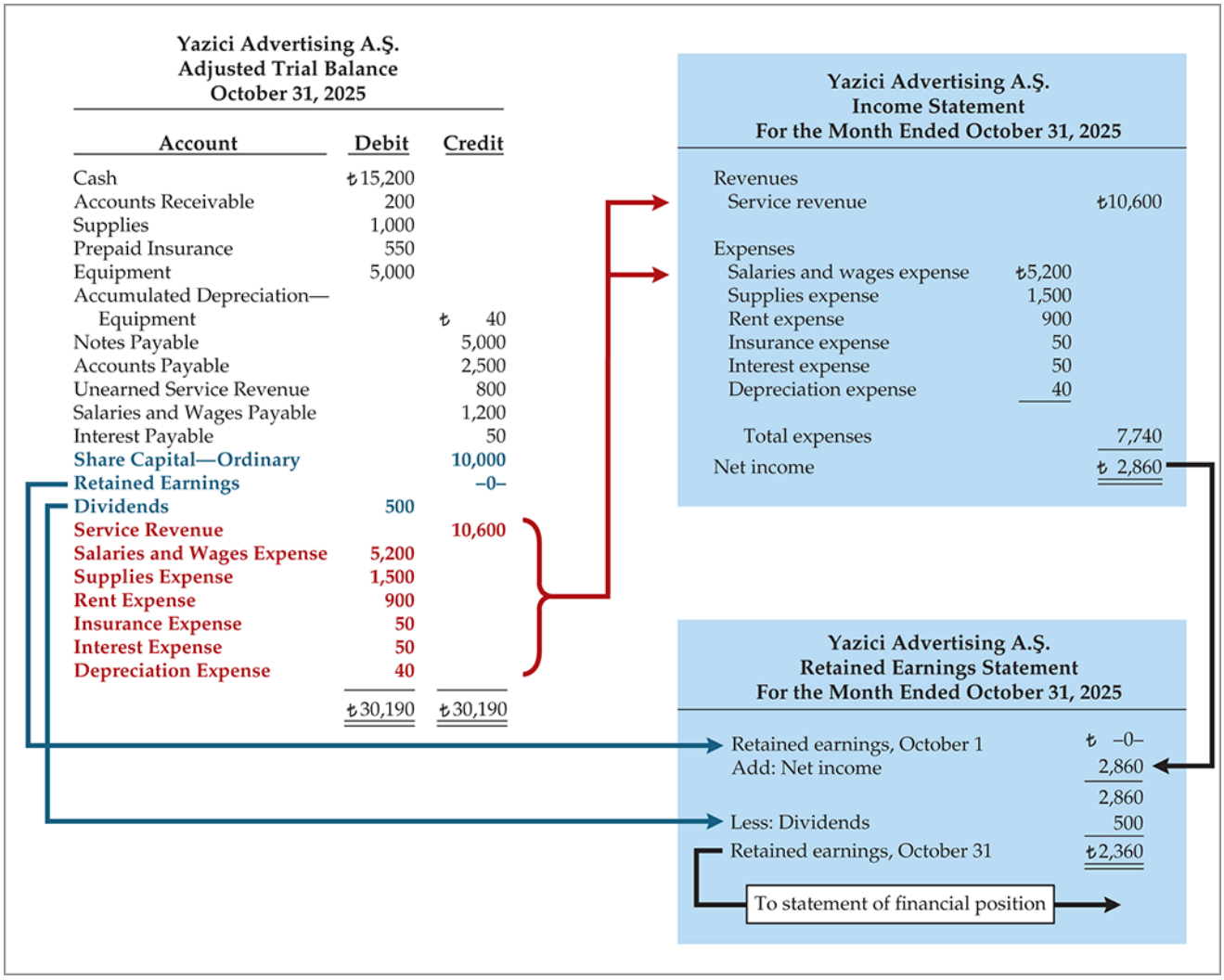
	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	₺30,190	₺30,190

Preparing Financial Statements

Companies can prepare financial statements directly from the adjusted trial balance. Illustrations 3.27 and 3.28 present the interrelationships of data in the adjusted trial balance and the financial statements.

As Illustration 3.27 shows, companies prepare the income statement from the revenue and expense accounts. Next, they use the Retained Earnings and Dividends accounts and the net income (or net loss) from the income statement to prepare the retained earnings statement.

ILLUSTRATION 3.27 Preparation of the income statement and retained earnings statement from the adjusted trial balance



Yazici Advertising A.Ş.
Adjusted Trial Balance
October 31, 2025

Account	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	₺30,190	₺30,190

Yazici Advertising A.Ş.
Income Statement
For the Month Ended October 31, 2025

Revenues		
Service revenue		₺10,600
Expenses		
Salaries and wages expense	₺5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		₺ 2,860

Yazici Advertising A.Ş.
Retained Earnings Statement
For the Month Ended October 31, 2025

Retained earnings, October 1	₺ –0–
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	₺2,360

To statement of financial position

As Illustration 3.28 shows, companies then prepare the statement of financial position from the asset and liability accounts and the ending Retained Earnings balance as reported in the retained earnings statement.

ILLUSTRATION 3.28 Preparation of the statement of financial position from the adjusted trial balance

Yazici Advertising A.Ş.
Adjusted Trial Balance
October 31, 2025

Account	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	₺30,190	₺30,190

Yazici Advertising A.Ş.
Statement of Financial Position
October 31, 2025

Assets

Equipment	₺5,000	
Less: Accumulated depreciation—equip.	40	₺ 4,960
Prepaid insurance		550
Supplies		1,000
Accounts receivable		200
Cash		15,200
Total assets		₺21,910

Equity and Liabilities

Equity		
Share capital—ordinary	₺10,000	
Retained earnings	2,360	₺12,360
Liabilities		
Notes payable	5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	9,550
Total equity and liabilities		₺21,910

Balance at Oct. 31 from retained earnings statement in Illustration 3.27

DO IT! 4

Trial Balance

Kang Company was organized on April 1, 2025. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below (amounts in millions).

	Debit		Credit
Cash	₩ 6,700	Accumulated Depreciation—Equipment	₩ 850
Accounts Receivable	600	Notes Payable	5,000
Prepaid Rent	900	Accounts Payable	1,510
Supplies	1,000	Salaries and Wages Payable	400
Equipment	15,000	Interest Payable	50
Dividends	600	Unearned Rent Revenue	500
Salaries and Wages Expense	9,400	Share Capital—Ordinary	14,000
Rent Expense	1,500	Service Revenue	14,200
Depreciation Expense	850	Rent Revenue	800
Supplies Expense	200		
Utilities Expense	510		
Interest Expense	50		
	₩37,310		₩37,310

a. Determine the net income for the quarter April 1 to June 30.

b. Determine the total assets and total liabilities at June 30, 2025, for Kang Company.

c. Determine the amount of retained earnings at June 30, 2025.

ACTION PLAN

- **In an adjusted trial balance, all asset, liability, revenue, and expense accounts are properly stated.**
- **To determine the ending balance in Retained Earnings, add net income and subtract dividends.**

Solution

Related exercise material: **BE3.11**, **BE3.12**, **DO IT! 3.4**, **E3.11**, **E3.12**, **and E3.19**.

Appendix 3A Alternative Treatment of Deferrals

LEARNING OBJECTIVE *5

Prepare adjusting entries for the alternative treatment of deferrals.

In discussing adjusting entries for prepaid expenses and unearned revenues, we illustrated transactions for which companies made the initial entries to statement of financial position accounts. In the case of prepaid expenses, the company debited the prepayment to an asset account. In the case of unearned revenue, the company credited a liability account to record the cash received.

Some companies use an alternative treatment.

1. When a company prepays an expense, it debits that amount to an expense account.
2. When it receives payment for future services, it credits the amount to a revenue account.

In this appendix, we describe the circumstances that justify such entries and the different adjusting entries that may be required. This alternative treatment of prepaid expenses and unearned revenues has the same effect on the financial statements as the procedures described in the chapter.

Prepaid Expenses

Prepaid expenses become expired costs either through the passage of time (e.g., insurance) or through consumption (e.g., advertising supplies).

- If at the time of purchase the company expects to consume all or most of the supplies before the next financial statement date, it may choose to debit (increase) an expense account rather than an asset account.
- This alternative treatment is simply more convenient.

Assume that Yazici Advertising expects that it will use before the end of the month all of the supplies purchased on October 5. A debit of ₺2,500 to Supplies Expense (rather than to the asset account Supplies) on October 5 will eliminate the need for an adjusting entry on October 31. At October 31, the Supplies Expense account will show a balance of ₺2,500, which is the cost of supplies used between October 5 and October 31.

But what if the company does not use all the supplies? For example, what if an inventory of ₺1,000 of advertising supplies remains on October 31? Obviously, the company would need to make an adjusting entry. Prior to adjustment, the expense account Supplies Expense is overstated ₺1,000, and the asset account Supplies is understated ₺1,000. Thus, Yazici makes the following adjusting entry.

Oct. 31	Supplies	1,000	
	Supplies Expense		1,000
	(To record supplies inventory)		

A	=	L	+	E
+1,000				
				+1,000 Exp

Cash Flows
no effect

Illustration 3A.1 shows the accounts after the company posts the adjusting entry.

ILLUSTRATION 3A.1 Prepaid expenses accounts after adjustment

Supplies			
10/31 **Adj.**	**1,000**		

Supplies Expense			
10/5	2,500	10/31 **Adj.**	**1,000**
10/31 **Bal.**	**1,500**		

After adjustment, the asset account Supplies shows a balance of ₺1,000, which is equal to the cost of supplies on hand at October 31. In addition, Supplies Expense shows a balance of ₺1,500. This is equal to the cost of supplies used between October 5 and October 31.

- Without the adjusting entry, expenses are overstated and net income is understated by ₺1,000 in the October income statement.
- Also, both assets and equity are understated by ₺1,000 on the October 31 statement of financial position.

Illustration 3A.2 compares the entries and accounts for advertising supplies in the two adjustment approaches.

ILLUSTRATION 3A.2 Adjustment approaches—a comparison

Prepayment Initially Debited to Asset Account (per chapter)				Prepayment Initially Debited to Expense Account (per appendix)			
Oct. 5	Supplies	2,500		Oct. 5	Supplies Expense	2,500	
	Accounts Payable		2,500		Accounts Payable		2,500
Oct. 31	Supplies Expense	1,500		Oct. 31	Supplies	1,000	
	Supplies		1,500		Supplies Expense		1,000

After Yazici posts the entries, the accounts appear as shown in Illustration 3A.3.

ILLUSTRATION 3A.3 Comparison of accounts

(per chapter)

Supplies

10/5	2,500	10/31 **Adj.**	**1,500**
10/31 **Bal.**	**1,000**		

Supplies Expense

10/31 **Adj.**	**1,500**		

(per appendix)

Supplies

10/31 **Adj.**	**1,000**		

Supplies Expense

10/5	2,500	10/31 **Adj.**	**1,000**
10/31 **Bal.**	**1,500**		

Note that the account balances under each alternative are the same at October 31: Supplies ₺1,000 and Supplies Expense ₺1,500.

Unearned Revenues

Unearned revenues are recognized as revenue at the time services are performed. Similar to the case for prepaid expenses, companies may credit (increase) a revenue account when they receive cash for future services.

To illustrate, assume that Yazici Advertising received ₺1,200 for future services on October 2. Yazici expects to perform the services before October 31.[1] In such a case, the company credits Service Revenue. If Yazici in fact performs the service before October 31, no adjustment is needed.

However, if at the statement date Yazici has not performed ₺800 of the services, it would make an adjusting entry (see Helpful Hint).

- Without the entry, the revenue account Service Revenue is overstated ₺800.
- The liability account Unearned Service Revenue is understated ₺800.

> **HELPFUL HINT**
>
> **The required adjusted balances here are Service Revenue ₺400 and Unearned Service Revenue ₺800.**

Thus, Yazici makes the following adjusting entry.

Oct. 31	Service Revenue	800	
	Unearned Service Revenue		800
	(To record unearned service revenue)		

A	=	L	+	E
				−800 Rev
		+800		

Cash Flows
no effect

Illustration 3A.4 shows the accounts after Yazici posts the adjusting entry.

ILLUSTRATION 3A.4 Unearned service revenue accounts after adjustment

Unearned Service Revenue

	10/31 **Adj.**		**800**

Service Revenue

10/31 **Adj.**	**800**	10/2	1,200
		10/31 **Bal.**	**400**

The liability account Unearned Service Revenue shows a balance of Ł800. This equals the services that will be performed in the future. In addition, the balance in Service Revenue equals the services performed in October.

- Without the adjusting entry, both revenues and net income are overstated by Ł800 in the October income statement.
- Also, liabilities are understated by 800 and equity is overstated by Ł800 on the October 31 statement of financial position.

Illustration 3A.5 compares the entries and accounts for initially recording unearned service revenue in (1) a liability account or (2) a revenue account.

ILLUSTRATION 3A.5 Adjustment approaches—a comparison

Unearned Service Revenue Initially Credited to Liability Account (per chapter)				**Unearned Service Revenue Initially Credited to Revenue Account (per appendix)**			
Oct. 2	Cash	1,200		Oct. 2	Cash	1,200	
	Unearned Service Revenue		1,200		Service Revenue		1,200
Oct. 31	Unearned Service Revenue	400		Oct. 31	Service Revenue	800	
	Service Revenue		400		Unearned Service Revenue		800

After Yazici posts the entries, the accounts appear as shown in Illustration 3A.6.

ILLUSTRATION 3A.6 Comparison of accounts

(per chapter)
Unearned Service Revenue

10/31 **Adj.**	**400**	10/2	1,200
		10/31 **Bal.**	**800**

Service Revenue

		10/31 **Adj.**	**400**

(per appendix)
Unearned Service Revenue

		10/31 **Adj.**	**800**

Service Revenue

10/31 **Adj.**	**800**	10/2	1,200
		10/31 **Bal.**	**400**

Note that the balances in the accounts are the same under the two alternatives: Unearned Service Revenue ₺800 and Service Revenue ₺400.

Summary of Additional Adjustment Relationships

Illustration 3A.7 provides a summary of basic relationships for deferrals.

ILLUSTRATION 3A.7 Summary of basic relationships for deferrals

Type of Adjustment	Reason for Adjustment	Account Balances Before Adjustment	Adjusting Entry
1. Prepaid expenses	(a) Prepaid expenses initially recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets
	(b) **Prepaid expenses initially recorded in expense accounts have not been used.**	**Assets understated. Expenses overstated.**	**Dr. Assets Cr. Expenses**
2. Unearned revenues	(a) Unearned revenues initially recorded in liability accounts are now recognized as revenue.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues
	(b) **Unearned revenues initially recorded in revenue accounts are still unearned.**	**Liabilities understated. Revenues overstated.**	**Dr. Revenues Cr. Liabilities**

Alternative adjusting entries **do not apply** to accrued revenues and accrued expenses because **no entries occur before companies make these types of adjusting entries**.

Appendix 3B Financial Reporting Concepts

LEARNING OBJECTIVE *6

Discuss financial reporting concepts.

This appendix provides a summary of the concepts used in this text. In addition, it provides other useful concepts which accountants use as a basis for recording and reporting financial information.

Qualities of Useful Information

The IASB developed a *Conceptual Framework for Financial Reporting*. The purpose of the framework is both to assist the IASB to develop standards based on consistent concepts and to aid financial statement preparers to develop accounting policies when there is no relevant standard.

- The framework begins by stating that the primary objective of financial reporting is to provide financial information that is **useful** to investors and creditors for making decisions about providing capital.
- Useful information should possess two fundamental qualities, relevance and faithful representation, as shown in Illustration 3B.1.

ILLUSTRATION 3B.1 Fundamental qualities of useful information



Relevance Accounting information has relevance if it would make a difference in a business decision. Information is considered relevant if it provides information that has **predictive value**, that is, helps provide accurate expectations about the future, and has **confirmatory value**, that is, confirms or corrects prior expectations. Materiality is a company-specific aspect of relevance. An item is material when its **size** makes it likely to influence the decision of an investor or creditor.



Faithful Representation Faithful representation means that information accurately depicts what really happened. To provide a faithful representation, information must be **complete** (nothing important has been omitted), **neutral** (is not biased toward one position or another), and **free from error**.

Enhancing Qualities

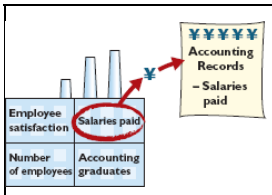
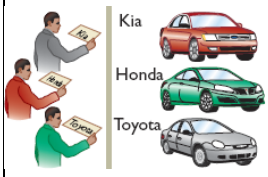
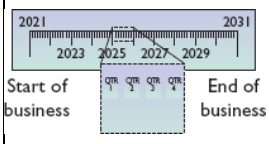
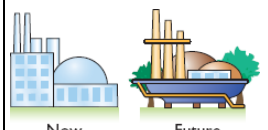
In addition to the two fundamental qualities, the IASB also describes a number of enhancing qualities of useful information. These include **comparability**, **verifiability**, **timeliness**, and **understandability**.

- Comparability results when different companies use the same accounting principles. Another type of comparability is consistency.
- Consistency means that a company uses the same accounting principles and methods from year to year.
- Information is verifiable if independent observers, using the same methods, obtain similar results.
- For accounting information to have relevance, it must be timely. That is, it must be available to decision-makers before it loses its capacity to influence decisions. For example, companies like **Tencent Holdings** (CHN) or **Asia Bicycle Trading Co.** (TWN) provide their annual reports to investors within 60 days of their year-end.
- Information has the quality of understandability if it is presented in a clear and concise fashion, so that reasonably informed users of that information can interpret it and comprehend its meaning.

Assumptions in Financial Reporting

To develop accounting standards, the IASB relies on some key assumptions, as shown in Illustration 3B.2. These include assumptions about the monetary unit, economic entity, time period, and going concern.

ILLUSTRATION 3B.2 Key assumptions in financial reporting

	**Monetary Unit Assumption** The monetary unit assumption requires that only those things that can be expressed in money are included in the accounting records. This means that certain important information needed by investors, creditors, and managers, such as customer satisfaction, is not reported in the financial statements. This assumption relies on the monetary unit remaining relatively stable in value.
	**Economic Entity Assumption** The economic entity assumption states that every economic entity can be separately identified and accounted for. In order to assess a company's performance and financial position accurately, it is important to not blur company transactions with personal transactions (especially those of its managers) or transactions of other companies.
	**Time Period Assumption** Notice that the income statement, retained earnings statement, and statement of cash flows all cover periods of one year, and the statement of financial position is prepared at the end of each year. The time period assumption states that the life of a business can be divided into artificial time periods and that useful reports covering those periods can be prepared for the business.
	**Going Concern Assumption** The going concern assumption states that the business will remain in operation for the foreseeable future. This assumption is used to justify, for example, valuing property, plant, and equipment at historical cost and using depreciation to allocate the cost of the asset to expense over its useful life. Of course, many businesses do fail. When the going concern assumption is not valid, other accounting methods not covered in this text are used.

Principles in Financial Reporting

Measurement Bases

IFRS generally uses one of two measurement bases, the historical cost basis or the current value basis. Selection of which basis to follow generally relates to trade-offs between relevance and faithful representation.

Historical Cost Basis

The historical cost basis (discussed in Chapter 1) dictates that companies record and continue to report assets at their cost. This is true not only at the time the asset is purchased but also over the time the asset is held. For example, if land that was purchased for €30,000 increases in value to €40,000, it continues to be reported at €30,000.

Current Value Basis

The current value basis (discussed in Chapter 1) indicates that assets and liabilities should be reported at current value. Current value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at current value because reliable market price information is often readily available for these types of assets.

In choosing between historical cost and current value, two qualities that make accounting information useful for decision-making are used—relevance and faithful representation.

- In determining which measurement basis to use, the factual nature of cost figures are weighed versus the relevance of current value.
- In general, most assets use the historical cost basis because current values may not be representationally faithful.
- Only in situations where assets are actively traded, such as investment securities, is the current value basis applied.

Revenue Recognition Principle

The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. As discussed earlier in the chapter, in a service company, revenue is recognized at the time the service is performed. In a merchandising company, the performance obligation is generally satisfied when the goods transfer from the seller to the buyer (discussed in Chapter 5). At this point, the sales transaction is complete and the sales price established.

Expense Recognition Principle

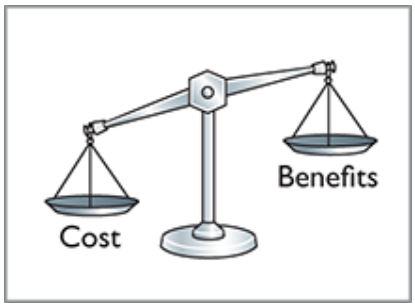
The **expense recognition principle** (discussed earlier in the chapter) dictates that companies recognize expense in the period in which they make efforts to generate revenue. Thus, expenses follow revenues.

Full Disclosure Principle

The **full disclosure principle** requires that companies disclose all circumstances and events that would make a difference to financial statement users. If an important item cannot reasonably be reported directly in one of the four types of financial statements, then it should be discussed in notes that accompany the statements.

Cost Constraint

Providing information is costly. In deciding whether companies should be required to provide a certain type of information, accounting standard-setters consider the **cost constraint**. It weighs the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.



Review and Practice

Learning Objectives Review

1 Explain the accrual basis of accounting and the reasons for adjusting entries.

The revenue recognition principle dictates that companies recognize revenue when a performance obligation has been satisfied. The expense recognition principle dictates that companies recognize expenses in the period when the company makes efforts to generate those revenues.

The time period assumption assumes that the economic life of a business is divided into artificial time periods. Accrual-basis accounting means that companies record events that change a company's financial statements in the periods in which those events occur, rather than in the periods in which the company receives or pays cash.

Companies make adjusting entries at the end of an accounting period. Such entries ensure that companies recognize revenues in the period in which the performance obligation is satisfied and recognize expenses in the period in which they are incurred. The major types of adjusting entries are deferrals (prepaid expenses and unearned revenues) and accruals (accrued revenues and accrued expenses).

2 Prepare adjusting entries for deferrals.

Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals to record the portion of the prepayment that represents the expense incurred or the revenue for services performed in the current accounting period.

3 Prepare adjusting entries for accruals.

Accruals are either accrued revenues or accrued expenses. Companies make adjusting entries for accruals to record revenues for services performed and expenses incurred in the current accounting period that have not been recognized through daily entries.

4 Describe the nature and purpose of an adjusted trial balance.

An adjusted trial balance shows the balances of all accounts, including those that have been adjusted, at the end of an accounting period. Its purpose is to prove the equality of the total debit balances and total credit balances in the ledger after all adjustments.

***5 Prepare adjusting entries for the alternative treatment of deferrals.**

Companies may initially debit prepayments to an expense account. Likewise, they may initially credit unearned revenues to a revenue account. At the end of the period, these accounts may be overstated. The adjusting entries for prepaid expenses are a debit to an asset account and a credit to an expense account. Adjusting entries for unearned revenues are a debit to a revenue account and a credit to a liability account.

***6 Discuss financial reporting concepts.**

To be judged useful, information should have the primary characteristics of relevance and faithful representation. In addition, it should be comparable, consistent, verifiable, timely, and understandable.

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The **economic entity assumption** states that economic events can be identified with a particular unit of accountability. The **time period assumption** states that the economic life of a business can be divided into artificial time periods and that meaningful accounting reports can be prepared for each period. The **going concern assumption** states that the company will continue in operation long enough to carry out its existing objectives and commitments.

The **historical cost basis** states that companies should record and continue to report assets at their cost. The **current value basis** indicates that assets and liabilities should be reported at current value. The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. The **expense recognition principle** dictates that efforts (expenses) be matched with results (revenues). The **full disclosure principle** requires that companies disclose circumstances and events that matter to financial statement users.

The **cost constraint** weighs the cost that companies incur to provide a type of information against its benefits to financial statement users.

Glossary Review

Accrual-basis accounting
Accounting basis in which companies record transactions that change a company's financial statements in the periods in which the events occur.

Accruals
Adjusting entries for either accrued revenues or accrued expenses.

Accrued expenses
Expenses incurred but not yet paid in cash or recorded.

Accrued revenues
Revenues for services performed but not yet received in cash or recorded.

Adjusted trial balance
A list of accounts and their balances after the company has made all adjustments.

Adjusting entries

Entries made at the end of an accounting period to ensure that companies follow the revenue recognition and expense recognition principles.

Book value
The difference between the cost of a depreciable asset and its related accumulated depreciation.

Calendar year
An accounting period that extends from January 1 to December 31.

Cash-basis accounting
Accounting basis in which companies record revenue when they receive cash and an expense when they pay out cash.

***Comparability**
Ability to compare the accounting information of different companies because they use the same accounting principles.

***Consistency**
Use of the same accounting principles and methods from year to year within a company.

Contra asset account
An account offset against an asset account on the statement of financial position.

***Cost constraint**
Constraint that weighs the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.

***Current value basis**
A measurement basis that results in the assets and liabilities being reported at current value.

Deferrals
Adjusting entries for either prepaid expenses or unearned revenues.

Depreciation
The process of allocating the cost of an asset to expense over its useful life.

***Economic entity assumption**
An assumption that every economic entity can be separately identified and accounted for.

Expense recognition principle
The principle that companies recognize expense in the period in which they make efforts (consume assets or incur liabilities) to generate revenue.

***Faithful representation**
Information that accurately depicts what really happened.

Fiscal year
An accounting period that is one year in length.

***Full disclosure principle**
Accounting principle that dictates that companies disclose circumstances and events that make a difference to financial statement users.

***Going concern assumption**
The assumption that the company will continue in operation for the foreseeable future.

***Historical cost basis**
A measurement basis that results in companies should record assets and other accounts at their cost.

Interim periods
Monthly or quarterly accounting time periods.

***Materiality**
A company-specific aspect of relevance. An item is material when its size makes it likely to influence the decision of an investor or creditor.

***Monetary unit assumption**
An assumption that requires that only those things that can be expressed in money are included in the accounting records.

Prepaid expenses (prepayments)
Expenses paid in cash before they are used or consumed.

***Relevance**

The quality of information that indicates the information makes a difference in a decision.

Revenue recognition principle
The principle that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

***Timely**
Information that is available to decision-makers before it loses its capacity to influence decisions.

Time period assumption
An assumption that accountants can divide the economic life of a business into artificial time periods.

***Understandability**
Information presented in a clear and concise fashion so that users can interpret it and comprehend its meaning.

Unearned revenues
A liability recorded for cash received before services are performed.

Useful life
The length of service of a long-lived asset.

***Verifiable**
The quality of information that occurs when independent observers, using the same methods, obtain similar results.

Practice Multiple-Choice Questions

1. **(LO 1)** The revenue recognition principle states that:

   a. revenue should be recognized in the accounting period in which a performance obligation is satisfied.

   b. expenses should be matched with revenues.

   c. the economic life of a business can be divided into artificial time periods.

   d. the fiscal year should correspond with the calendar year.

Solution

2. **(LO 1)** The time period assumption states that:

   a. companies must wait until the calendar year is completed to prepare financial statements.

   b. companies use the fiscal year to report financial information.

   c. the economic life of a business can be divided into artificial time periods.

   d. companies record information in the time period in which the events occur.

Solution

3. **(LO 1)** Which of the following statements about the accrual basis of accounting is **false**?

   a. Events that change a company's financial statements are recorded in the periods in which the events occur.

   b. Revenue is recognized in the period in which services are performed.

   c. This basis is in accordance with International Financial Reporting Standards.

   d. Revenue is recorded only when cash is received, and expense is recorded only when cash is paid.

Solution

4. **(LO 1)** The principle or assumption dictating that efforts (expenses) should be recognized in the period in which a company consumes assets or incurs liabilities to generate revenue is the:

   a. expense recognition principle.

   b. cost assumption.

   c. time period assumption.

d. revenue recognition principle.

Solution

5. **(LO 1)** Adjusting entries are made to ensure that:

a. expenses are recognized in the period in which they are incurred.

b. revenues are recorded in the period in which services are performed.

c. statement of financial position and income statement accounts have correct balances at the end of an accounting period.

d. All of the answer choices are correct.

Solution

6. **(LO 1)** Each of the following is a major type (or category) of adjusting entries **except**:

a. prepaid expenses.

b. accrued revenues.

c. accrued expenses.

d. recognized revenues.

Solution

7. **(LO 2)** The trial balance shows Supplies €1,350 and Supplies Expense €0. If €600 of supplies are on hand at the end of the period, the adjusting entry is:

a. Supplies	600	
Supplies Expense		600
b. Supplies	750	
Supplies Expense		750
c. Supplies Expense	750	
Supplies		750
d. Supplies Expense	600	
Supplies		600

Solution

8. **(LO 2)** Adjustments for prepaid expenses:

a. decrease assets and increase revenues.

b. decrease expenses and increase assets.

c. decrease assets and increase expenses.

d. decrease revenues and increase assets.

Solution

9. **(LO 2)** Accumulated Depreciation is:

a. a contra asset account.

b. an expense account.

c. an equity account.

d. a liability account.

Solution

10. **(LO 2)** Rivera Shipping computes depreciation on delivery equipment at ¥1,000 (amounts in thousands) for the month of June. The adjusting entry to record this depreciation is as follows.

a.	Depreciation Expense	1,000	
	Accumulated Depreciation—Rivera Shipping		1,000
b.	Depreciation Expense	1,000	
	Equipment		1,000
c.	Depreciation Expense	1,000	
	Accumulated Depreciation—Equipment		1,000
d.	Equipment Expense	1,000	
	Accumulated Depreciation—Equipment		1,000

Solution

11. **(LO 2)** Adjustments for unearned revenues:

a. decrease liabilities and increase revenues.

b. have an assets-and-revenues-account relationship.

c. increase assets and increase revenues.

d. decrease revenues and decrease assets.

Solution

12. **(LO 3)** Adjustments for accrued revenues:

a. have a liabilities-and-revenues-account relationship.

b. have an assets-and-revenues-account relationship.

c. decrease assets and revenues.

d. decrease liabilities and increase revenues.

Solution

13. **(LO 3)** Anika Winter earned a salary of €400 for the last week of September. She will be paid on October 1. The adjusting entry for Anika's employer at September 30 is:

a. No entry is required.

b.	Salaries and Wages Expense	400	
	Salaries and Wages Payable		400
c.	Salaries and Wages Expense	400	
	Cash		400
d.	Salaries and Wages Payable	400	
	Cash		400

Solution

14. **(LO 4)** Which of the following statements is **incorrect** concerning the adjusted trial balance?

a. An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.

b. The adjusted trial balance provides the primary basis for the preparation of financial statements.

c. The adjusted trial balance lists the account balances segregated by assets and liabilities.

d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.

Solution

*15. (LO 5) The trial balance shows Supplies NT$0 and Supplies Expense NT$1,500. If NT$800 of supplies are on hand at the end of the period, the adjusting entry is:

a. debit Supplies NT$800 and credit Supplies Expense NT$800.

b. debit Supplies Expense NT$800 and credit Supplies NT$800.

c. debit Supplies NT$700 and credit Supplies Expense NT$700.

d. debit Supplies Expense NT$700 and credit Supplies NT$700.

Solution

*16. (LO 6) Neutrality is an ingredient of:

	Faithful Representation	Relevance
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

Solution

*17. (LO 6) Which item is a constraint in financial accounting?

a. Comparability.

b. Materiality.

c. Cost.

d. Consistency.

Solution

Practice Brief Exercises

Indicate why adjusting entries are needed.

1. (LO 1) The ledger of Dey Company includes the following accounts. Explain why each account may need adjustment.

a. Supplies.

b. Unearned Service Revenue.

c. Salaries and Wages Payable.

d. Interest Payable.

Solution

Prepare adjusting entry for depreciation.

2. **(LO 2)** At the end of its first year, the trial balance of Denton Cleaners shows Equipment of £40,000 and zero balances in Accumulated Depreciation—Equipment and Depreciation Expense. Depreciation for the year is estimated to be £8,000. Prepare the adjusting entry for depreciation at December 31, post the adjustments to T-accounts, and indicate the statement of financial position presentation of the equipment at December 31.

Solution

Prepare adjusting entries for accruals.

3. **(LO 3)** You are asked to prepare the following accrual adjusting entries at December 31.

1. Services performed but not recorded are €4,200.
2. Utilities expenses incurred but not paid are €660.
3. Salaries and wages earned by employees of €3,000 are unpaid.

Use the following account titles: Accounts Receivable, Service Revenue, Salaries and Wages Expense, Salaries and Wages Payable, Utilities Expense, and Utilities Payable.

Solution

Analyze accounts in an unadjusted trial balance.

4. **(LO 1, 2, 3)** The trial balance for Blair Company includes the following statement of financial position accounts. Identify the accounts that may require adjustment. For each account that requires adjustment, indicate (a) the type of adjusting entry (prepaid expense, unearned revenue, accrued revenue, or accrued expense) and (b) the related account in the adjusting entry.

Accounts Receivable	Interest Payable
Supplies	Unearned Service Revenue
Prepaid Insurance	

Solution

Prepare an income statement from an adjusted trial balance.

5. **(LO 4)** The adjusted trial balance of Harmony Decorating includes the following accounts at December 31, 2025: Cash €12,000, Share Capital—Ordinary €22,000, Dividends €3,000, Service Revenue €41,000, Rent Expense €900, Salaries and Wages Expense €6,000, Supplies Expense €700, and Depreciation Expense €1,800. Prepare an income statement for the year.

Solution

Practice Exercises

Prepare adjusting entries.

1. **(LO 2, 3)** Evan Watts, D.D.S., opened a dental practice on January 1, 2025. During the first month of operations, the following transactions occurred.

1. Watts performed services for patients totaling $2,400. These services have not yet been recorded.
2. Utilities expenses incurred but not paid prior to January 31 totaled $400.

3. Purchased dental equipment on January 1 for $80,000, paying $20,000 in cash and signing a $60,000, 3-year note payable. The equipment depreciates $500 per month. Interest is $600 per month.
4. Purchased a one-year malpractice insurance policy on January 1 for $12,000.
5. Purchased $2,600 of dental supplies. On January 31, determined that $900 of supplies were on hand.

Instructions

Prepare the adjusting entries on January 31. Account titles are Accumulated Depreciation—Equipment, Depreciation Expense, Service Revenue, Accounts Receivable, Insurance Expense, Interest Expense, Interest Payable, Prepaid Insurance, Supplies, Supplies Expense, Utilities Expense, and Utilities Payable.

Solution

Prepare correct income statement.

2. (LO 2, 3, 4) The income statement of Venden Movers for the month of July shows net income of £4,000 based on Service Revenue £8,700, Salaries and Wages Expense £2,500, Supplies Expense £1,700, and Utilities Expense £500. In reviewing the statement, you discover the following.

1. Insurance expired during July of £700 was omitted.
2. Supplies expense includes £250 of supplies that are still on hand at July 31.
3. Depreciation on equipment of £300 was omitted.
4. Accrued but unpaid wages at July 31 of £400 were not included.
5. Services performed but unrecorded totaled £650.

Instructions

Prepare a correct income statement for July 2025.

Solution

Practice Problem

Prepare adjusting entries from selected data.

(LO 2, 3) The Desai Lawn Care began operations on April 1. At April 30, the trial balance shows the following balances for selected accounts (amounts in thousands).

Prepaid Insurance	₹ 3,600
Equipment	28,000
Notes Payable	20,000
Unearned Service Revenue	4,200
Service Revenue	1,800

Analysis reveals the following additional data.

1. Prepaid insurance is the cost of a 2-year insurance policy, effective April 1.
2. Depreciation on the equipment is ₹500 per month.
3. The note payable is dated April 1. It is a 6-month, 12% note.
4. Seven customers paid for the company's 6-month lawn service package of ₹600 beginning in April. The company performed services for these customers in April.
5. Lawn services performed for other customers but not recorded at April 30 totaled ₹1,500.

Instructions

Prepare the adjusting entries for the month of April. Show computations.

Solution

Note: All asterisked Questions, Exercises, and Problems relate to material in the appendices to the chapter.

Questions

1.

a. How does the time period assumption affect an accountant's analysis of business transactions?

b. Explain the terms fiscal year, calendar year, and interim periods.

2. Define two IFRSs that relate to adjusting the accounts.

3. What are the five steps of the revenue recognition process?

4. Susan Hardy, a lawyer, accepts a legal engagement in March, performs the work in April, and is paid in May. If Hardy's law firm prepares monthly financial statements, when should it recognize revenue from this engagement? Why?

5. Why do accrual-basis financial statements provide more useful information than cash-basis statements?

6. In completing the engagement in Question 4, Hardy pays no costs in March, £2,000 in April, and £2,500 in May (incurred in April). How much expense should the firm deduct from revenues in the month when it recognizes the revenue? Why?

7. "Adjusting entries are required by the historical cost basis of accounting." Do you agree? Explain.

8. Why may a trial balance not contain up-to-date and complete financial information?

9. Distinguish between the two categories of adjusting entries, and identify the types of adjustments applicable to each category.

10. What is the debit/credit effect of a prepaid expense adjusting entry?

11. "Depreciation is a valuation process that results in the reporting of the current value of the asset." Do you agree? Explain.

12. Explain the differences between depreciation expense and accumulated depreciation.

13. G. Phillips Company purchased equipment for Rs18,000. By the current statement of financial position date, Rs6,000 had been depreciated. Indicate the statement of financial position presentation of the data.

14. What is the debit/credit effect of an unearned revenue adjusting entry?

15. Whistler Cabinets performed services for a customer but has not yet recorded payment, nor has it recorded any entry related to the work. Which of the following accounts are involved in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense? For the accounts selected, indicate whether they would be debited or credited in the entry.

16. A company fails to recognize an expense incurred but not paid. Indicate which of the following accounts is debited and which is credited in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense.

17. A company makes an accrued revenue adjusting entry for NT$27,000 and an accrued expense adjusting entry for NT$21,000. How much was net income understated prior to these entries? Explain.

18. On January 9, a company pays €6,000 for salaries and wages of which €2,000 was reported as Salaries and Wages Payable on December 31. Give the entry to record the payment.

19. For each of the following items before adjustment, indicate the type of adjusting entry (prepaid expense, unearned revenue, accrued revenue, or accrued expense) that is needed to correct the misstatement. If an item could result in more than one type of adjusting entry, indicate each of the types.

a. Assets are understated.

b. Liabilities are overstated.

c. Liabilities are understated.

d. Expenses are understated.

e. Assets are overstated.

f. Revenue is understated.

20. One-half of the adjusting entry is given below. Indicate the account title for the other half of the entry.

a. Salaries and Wages Expense is debited.

b. Depreciation Expense is debited.

c. Interest Payable is credited.

d. Supplies is credited.

e. Accounts Receivable is debited.

f. Unearned Service Revenue is debited.

21. "An adjusting entry may affect more than one statement of financial position or income statement account." Do you agree? Why or why not?

22. Why is it possible to prepare financial statements directly from an adjusted trial balance?

***23.** Dashan Company debits Supplies Expense for all purchases of supplies and credits Rent Revenue for all advanced rentals. For each type of adjustment, give the adjusting entry.

***24.**

a. What is the primary objective of financial reporting?

b. Identify the characteristics of useful accounting information.

***25.** Dan Fineman, the president of King Company, is pleased. King substantially increased its net income in 2025 while keeping its unit inventory relatively the same. However, Howard Gross, chief accountant, cautions Dan. Gross says that since King changed its method of inventory valuation, there is a consistency problem and it is difficult to determine whether King is better off. Is Gross correct? Why or why not?

***26.** What is the distinction between comparability and consistency?

***27.** Describe the constraint inherent in the presentation of accounting information.

***28.** Quinn Becker is president of Better Books. She has no accounting background. Becker cannot understand why current value is not used as the basis for all accounting measurement and reporting. Discuss.

***29.** What is the economic entity assumption? Give an example of its violation.

Brief Exercises

Identify the order of the five steps in the revenue recognition process.

BE3.1 (LO 1) Number the following steps of the revenue recognition process (from 1–5) to place in the correct order.

a. _____ Allocate the transaction price to the separate performance obligations.

b. _____ Identify the contract with customers.

c. _____ Identify the separate performance obligations in the contract.

d. _____ Recognize revenue when each performance obligation is satisfied.

e. _____ Determine the transaction price.

Identify impact of transactions on cash and net income.

BE3.2 (LO 1) Transactions that affect net income do not necessarily affect cash. Identify the effect, if any, that each of the following transactions would have upon cash and net income. The first transaction has been completed as an example.

	Cash	Net Income
a. Purchased $100 of supplies for cash.	−$100	$0

b. Recorded an adjusting entry to record use of $20 of the above supplies.

c. Made sales of $1,300, all on account.

d. Received $800 from customers in payment of their accounts.

e. Purchased equipment for cash, $2,500.

f. Recorded depreciation of building for period used, $600.

Indicate why adjusting entries are needed.

BE3.3 (LO 1) The ledger of Althukair Company includes the following accounts. Explain why each account may require adjustment.

a. Prepaid Insurance.

b. Depreciation Expense.

c. Unearned Service Revenue.

d. Interest Payable.

Identify the major types of adjusting entries.

BE3.4 (LO 2, 3) Gee Company accumulates the following adjustment data at December 31. Indicate (a) the type of adjustment (prepaid expense, accrued revenue, and so on), and (b) the status of accounts before adjustment (for example, "assets understated and revenues understated").

1. Supplies of €150 are on hand.
2. Services performed but not recorded total €900.
3. Interest of €200 has accumulated on a note payable.
4. Rent collected in advance totaling €850 has been recognized as revenue.

Prepare adjusting entry for supplies.

BE3.5 (LO 2) Schramel Advertising's trial balance at December 31 shows Supplies £6,700 and Supplies Expense £0. On December 31, there are £2,100 of supplies on hand. Prepare the adjusting entry at December 31, and using T-accounts, enter the balances in the accounts, post the adjusting entry, and indicate the adjusted balance in each account.

Prepare adjusting entry for depreciation.

BE3.6 (LO 2) At the end of its first year, the trial balance of Wolowitz Company shows Equipment €30,000 and zero balances in Accumulated Depreciation—Equipment and Depreciation Expense. Depreciation for the year is estimated to be €3,750. Prepare the annual adjusting entry for depreciation at December 31, post the adjustments to T-accounts, and indicate the statement of financial position presentation of the equipment at December 31.

Prepare adjusting entry for prepaid expense.

BE3.7 (LO 2) On July 1, 2025, Major Ltd. pays £15,120 to Orlow Insurance for a 3-year insurance contract. Both companies have fiscal years ending December 31. For Major Ltd., journalize and post the entry on July 1 and the annual adjusting entry on December 31.

Prepare adjusting entry for unearned revenue.

BE3.8 (LO 2) Using the data in BE3.7, journalize and post the entry on July 1 and the adjusting entry on December 31 for Orlow Insurance. Orlow uses the accounts Unearned Service Revenue and Service Revenue.

Prepare adjusting entries for accruals.

BE3.9 (LO 3) The bookkeeper for Abduli Marble asks you to prepare the following accrual adjusting entries at December 31.

1. Interest on notes payable of €400 is accrued.
2. Services performed but not recorded total €2,300.
3. Salaries earned by employees of €900 have not been recorded.

Use the following account titles: Service Revenue, Accounts Receivable, Interest Expense, Interest Payable, Salaries and Wages Expense, and Salaries and Wages Payable.

Analyze accounts in an unadjusted trial balance.

BE3.10 (LO 2, 3) The trial balance of Beowulf Travel includes the following statement of financial position accounts, which may require adjustment. For each account that requires adjustment, indicate (a) the type of adjusting entry (prepaid expense, unearned revenue, accrued revenue, or accrued expense) and (b) the related account in the adjusting entry.

Accounts Receivable	Interest Payable
Prepaid Insurance	Unearned Service Revenue
Accumulated Depreciation—Equipment	

Prepare an income statement from an adjusted trial balance.

BE3.11 (LO 4) The adjusted trial balance of Kwun Photos at December 31, 2025, includes the following accounts: Share Capital—Ordinary ₩16,400, Dividends ₩7,000, Service Revenue ₩39,000, Salaries and Wages Expense ₩16,000, Insurance Expense ₩2,000, Rent Expense ₩4,000, Supplies Expense ₩1,500, and Depreciation Expense ₩1,300. Prepare an income statement for the year (amounts in thousands).

Prepare a retained earnings statement from an adjusted trial balance.

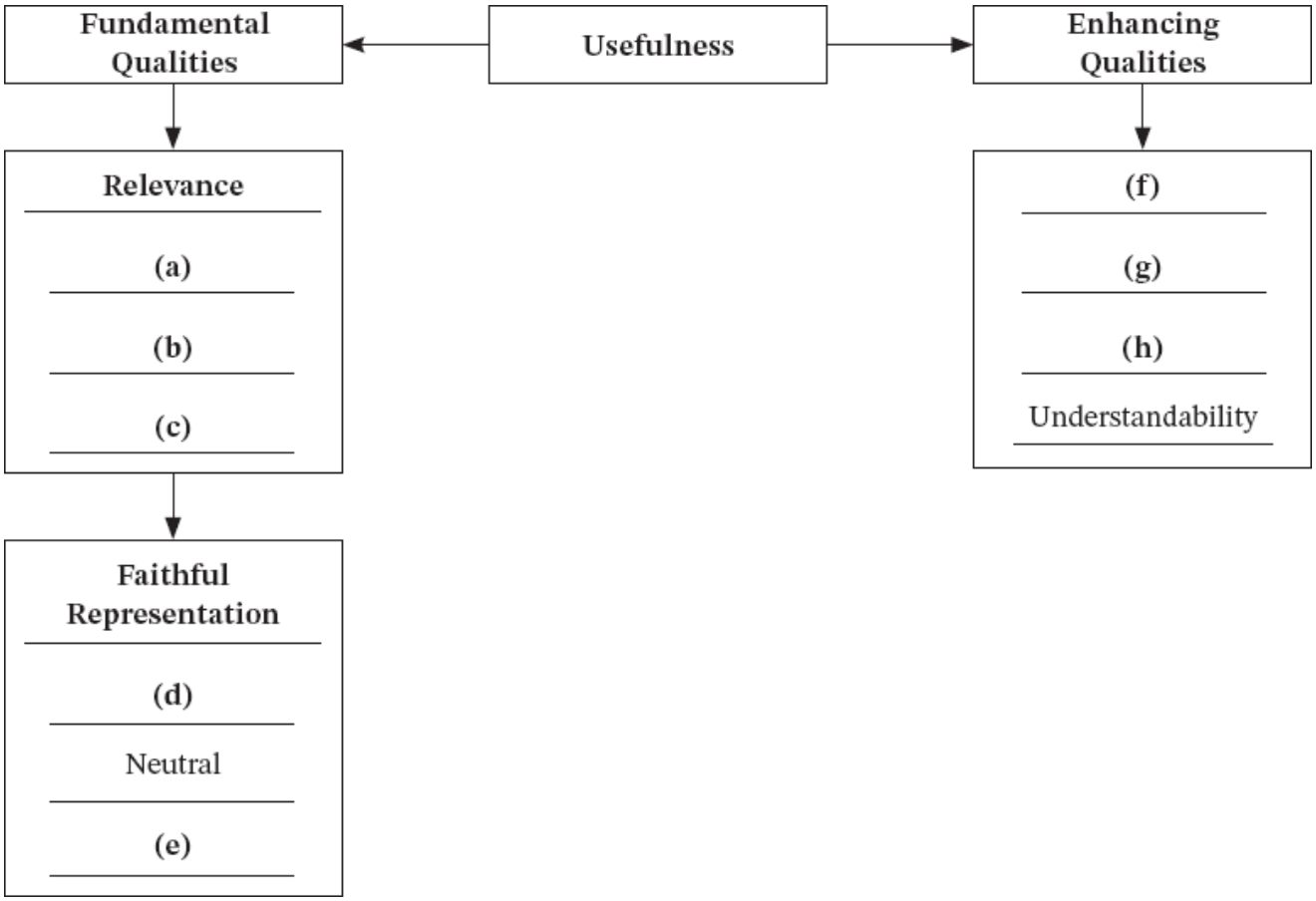
BE3.12 (LO 4) Partial adjusted trial balance data for Kwun Photos is presented in BE3.11. Prepare a retained earnings statement for the year assuming net income is ₩14,200 for the year and Retained Earnings is ₩7,240 on January 1 (amounts in thousands).

Prepare adjusting entries under alternative treatment of deferrals.

***BE3.13 (LO 5)** Eckholm Pet Grooming records all prepayments in income statement accounts. At April 30, the trial balance shows Supplies Expense HK$28,000, Service Revenue HK$92,000, and zero balances in related statement of financial position accounts. Prepare the adjusting entries at April 30 assuming (a) HK$4,000 of supplies on hand and (b) HK$30,000 of service revenue should be reported as unearned.

Identify characteristics of useful information.

***BE3.14 (LO 6)** The accompanying chart shows the qualitative characteristics of useful accounting information. Fill in the blanks.



Identify characteristics of useful information.

***BE3.15 (LO 6)** Given the characteristics of useful accounting information, complete each of the following statements.

a. For information to be _____, it should have predictive value, confirmatory value, and be material.

b. _____ is the quality of information that gives assurance that the information accurately depicts what really happened.

c. _____ means using the same accounting principles and methods from year to year within a company.

Identify characteristics of useful information.

***BE3.16 (LO 6)** Here are some qualitative characteristics of useful accounting information:

1. Predictive value.
2. Neutral.
3. Verifiable.
4. Timely.

Match each qualitative characteristic to one of the following statements.

_____ **a.** Accounting information should help provide accurate expectations about future events.

_____ **b.** Accounting information cannot be selected, prepared, or presented to favor one set of interested users over another.

_____ **c.** The quality of information that occurs when independent observers, using the same methods, obtain similar results.

_____ **d.** Accounting information must be available to decision-makers before it loses its capacity to influence their decisions.

Define full disclosure principle.

***BE3.17 (LO 6)** Select the response that completes the following statement correctly. The full disclosure principle dictates that:

a. financial statements should disclose all assets at their cost.

b. financial statements should disclose only those events that can be measured in currency.

c. financial statements should disclose all events and circumstances that would matter to users of financial statements.

d. financial statements should not be relied on unless an auditor has expressed an unqualified opinion on them.

DO IT! Exercises

Identify timing concepts.

DO IT! 3.1 (LO 1) Below is a list of concepts in the left column, with a description of the concept in the right column. There are more descriptions provided than concepts. Match the description of the concept to the concept.

1. _____ Cash-basis accounting.
2. _____ Fiscal year.
3. _____ Revenue recognition principle.
4. _____ Expense recognition principle.

a. Monthly and quarterly time periods.

b. Accountants divide the economic life of a business into artificial time periods.

c. Efforts (expenses) should be recognized in the period in which a company uses assets or incurs liabilities to generate accomplishments (revenues).

d. Companies record revenues when they receive cash and record expenses when they pay out cash.

e. An accounting time period that is one year in length.

f. An accounting time period that starts on January 1 and ends on December 31.

g. Companies record transactions in the period in which the events occur.

h. Recognize revenue in the accounting period in which a performance obligation is satisfied.

Prepare adjusting entries for deferrals.

DO IT! 3.2 (LO 2) The ledger of Lafayette Ski School on March 31, 2025, includes the following selected accounts before adjusting entries.

	Debit	Credit
Prepaid Insurance	CHF 2,400	
Supplies	2,500	
Equipment	30,000	
Unearned Service Revenue		CHF9,000

An analysis of the accounts shows the following.

1. Insurance expires at the rate of CHF400 per month.
2. Supplies on hand total CHF1,600.
3. The equipment depreciates CHF480 per month.
4. During March, services were performed for two-fifths of the unearned service revenue.

Prepare the adjusting entries for the month of March.

Prepare adjusting entries for accruals.

DO IT! 3.3 (LO 3) Pegasus Computer Services began operations in July 2025. At the end of the month, the company prepares monthly financial statements. It has the following information for the month.

1. At July 31, the company owed employees €1,300 in salaries that the company will pay in August.
2. On July 1, the company borrowed €20,000 from a local bank on a 10-year note. The annual interest rate is 6%.
3. Service revenue unrecorded in July totaled €2,400.

Prepare the adjusting entries needed at July 31, 2025.

Calculate amounts from trial balance.

DO IT! 3.4 (LO 4) Ming Co. was organized on April 1, 2025. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are as follows.

	Debit		Credit
Cash	R$ 5,360	Accumulated Depreciation—Equipment	R$ 700
Accounts Receivable	580	Notes Payable	4,000
Prepaid Rent	1,120	Accounts Payable	790
Supplies	920	Salaries and Wages Payable	300
Equipment	12,000	Interest Payable	40
Dividends	500	Unearned Rent Revenue	400
Salaries and Wages Expense	7,400	Share Capital—Ordinary	11,200
Rent Expense	1,200	Service Revenue	11,360
Depreciation Expense	700	Rent Revenue	1,600
Supplies Expense	160		R$30,390
Utilities Expense	410		
Interest Expense	40		
	R$30,390		

a. Determine the net income for the quarter April 1 to June 30.

b. Determine the total assets and total liabilities at June 30, 2025, for Ming Co.

c. Determine the amount that appears for Retained Earnings at June 30, 2025.

Exercises

Determine point of revenue recognition.

E3.1 (LO 1) The following independent situations require professional judgment for determining when to recognize revenue from the transactions.

a. **Singapore Airlines** (SGP) sells you an advance-purchase airline ticket in September for your flight in December.

b. **Ultimate Electronics** (USA) sells you a home theater on a "no money down and full payment in three months" promotional deal.

c. The **Toronto Blue Jays** (CAN) sell season tickets online to games in the Skydome. Fans can purchase the tickets at any time, although the season doesn't officially begin until April. The major league baseball season runs from April through October.

d. **Barclays plc** (GBR) loans money on August 1. The loan and the interest are repayable in full in November.

e. In August, a customer orders a sweater from the **Target** (USA) website, paying with a Target credit card. The sweater arrives in September. Target sends a bill in October and receives payment in October.

Instructions

Identify when revenue should be recognized in each of the above situations.

Explain the time period assumption.

E3.2 (LO 1) Chloe Davis has prepared the following list of statements about the time period assumption.

1. Adjusting entries would not be necessary if a company's life were not divided into artificial time periods.
2. Taxing authorities require companies to file annual tax returns.
3. Accountants divide the economic life of a business into artificial time periods, but each transaction affects only one of these periods.
4. Accounting time periods are generally a month, a quarter, or a year.
5. A time period lasting one year is called an interim period.
6. All fiscal years are calendar years, but not all calendar years are fiscal years.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Distinguish between cash and accrual basis of accounting.

E3.3 (LO 1) Writing On numerous occasions, proposals have surfaced to put governments on the accrual basis of accounting. This is no small issue. In many cases, significant unrecorded liabilities and losses would have to be recorded.

Instructions

a. What is the difference between accrual-basis accounting and cash-basis accounting?

b. Why would politicians prefer the cash basis over the accrual basis?

c. Explain in a letter why governments should adopt the accrual basis of accounting.

Compute cash and accrual accounting income.

E3.4 (LO 1) Carillo Painting collected £108,000 from customers in 2025. Of the amount collected, £25,000 was for services performed in 2024. In addition, Carillo performed services worth £36,000 in 2025, which will not be collected until 2026.

Carillo Painting also paid £72,000 for expenses in 2025. Of the amount paid, £30,000 was for expenses incurred on account in 2024. In addition, Carillo incurred £42,000 of expenses in 2025, which will not be paid until 2026.

Instructions

a. Compute 2025 cash-basis net income.

b. Compute 2025 accrual-basis net income.

Identify the type of adjusting entry needed.

E3.5 (LO 1, 2, 3) Yilmaz A.Ş. encounters the following situations:

1. Yilmaz collects 1,300 from a customer in 2025 for services to be performed in 2026.
2. Yilmaz incurs utilities expense that is not yet paid in cash or recorded.
3. Yilmaz's employees worked 3 days in 2025 but will not be paid until 2026.
4. Yilmaz performs services for customers but has not yet received cash or recorded the transaction.
5. Yilmaz paid ₺2,800 rent on December 1 for the 4 months starting December 1.
6. Yilmaz received cash for future services and recorded a liability until the service was performed.
7. Yilmaz performed consulting services for a client in December 2025. On December 31, it had not billed the client for services provided of 1,200.
8. Yilmaz paid cash for an expense and recorded an asset until the item was used up.
9. Yilmaz purchased 900 of supplies in 2025; at year-end, 400 of supplies remain unused.
10. Yilmaz purchased equipment on January 1, 2025; the equipment will be used for 5 years.
11. Yilmaz borrowed 12,000 on October 1, 2025, signing an 8% one-year note payable.

Instructions

Identify what type of adjusting entry (prepaid expense, unearned revenue, accrued expense, or accrued revenue) is needed in each situation at December 31, 2025.

Prepare adjusting entries from selected data.

E3.6 (LO 2, 3) Hwang Ltd. has the following balances in selected accounts on December 31, 2025.

Accounts Receivable	NT$ –0–
Accumulated Depreciation—Equipment	–0–
Equipment	7,000
Interest Payable	–0–
Notes Payable	10,000
Prepaid Insurance	2,100
Salaries and Wages Payable	–0–
Supplies	2,450
Unearned Service Revenue	32,000

All the accounts have normal balances. The information below has been gathered at December 31, 2025.

1. Hwang borrowed NT$10,000 by signing a 9%, one-year note on September 1, 2025.
2. A count of supplies on December 31, 2025, indicates that supplies of NT$900 are on hand.
3. Depreciation on the equipment for 2025 is NT$1,000.
4. Hwang paid NT$2,100 for 12 months of insurance coverage on June 1, 2025.
5. On December 1, 2025, Hwang collected NT$32,000 for consulting services to be performed from December 1, 2025, through March 31, 2026.
6. Hwang performed consulting services for a client in December 2025. The client will be billed NT$4,200.
7. Hwang pays its employees total salaries of NT$9,000 every Monday for the preceding 5-day week (Monday through Friday). On Monday, December 29, employees were paid for the week ending December 26. All employees worked the last 3 days of 2025.

Instructions

Prepare annual adjusting entries for the seven items described above.

Identify types of adjustments and account relationships.

E3.7 (LO 2, 3) Orwell Surf Shop accumulates the following adjustment data at December 31.

1. Services performed but unbilled total €3,000.
2. Supplies of €300 have been used.
3. Utilities expenses of €552 are unpaid.
4. Services performed of €260 collected in advance.
5. Salaries of €800 are unpaid.
6. Prepaid insurance totaling €350 has expired.

Instructions

For each of the above items indicate the following.

a. The type of adjustment (prepaid expense, unearned revenue, accrued revenue, or accrued expense).

b. The status of accounts before adjustment (overstatement or understatement).

Prepare adjusting entries from selected account data.

E3.8 (LO 2, 3) The ledger of Villa Rental Agency on March 31 of the current year includes the selected accounts, shown below, before adjusting entries have been prepared.

	Debit	Credit
Prepaid Insurance	€ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		€ 8,400
Notes Payable		20,000
Unearned Rent Revenue		10,200
Rent Revenue		60,000
Interest Expense	–0–	
Salaries and Wages Expense	14,000	

An analysis of the accounts shows the following.

1. The equipment depreciates €400 per month.
2. One-third of the unearned rent revenue was recognized as revenue during the quarter.
3. Interest of €500 is accrued on the notes payable.
4. Supplies on hand total €750.
5. Insurance expires at the rate of €300 per month.

Instructions

Prepare the adjusting entries at March 31, assuming that adjusting entries are made **quarterly**. Additional accounts are Depreciation Expense, Insurance Expense, Interest Payable, and Supplies Expense.

Prepare adjusting entries.

E3.9 (LO 2, 3) Lorena Manzone opened a dental practice on January 1, 2025. During the first month of operations, the following transactions occurred.

1. Performed services for patients who had dental plan insurance. At January 31, €785 of such services were performed but not yet recorded.
2. Utilities expenses incurred but not paid prior to January 31 totaled €650.
3. Purchased dental equipment on January 1 for €80,000, paying €30,000 in cash and signing a €50,000, 3-year note payable. The equipment depreciates €400 per month. Interest is €500 per month.
4. Purchased a one-year malpractice insurance policy on January 1 for €24,000.
5. Purchased €1,600 of dental supplies. On January 31, determined that €400 of supplies were on hand.

Instructions

Prepare the adjusting entries on January 31. Account titles are Accumulated Depreciation—Equipment, Depreciation Expense, Service Revenue, Accounts Receivable, Insurance Expense, Interest Expense, Interest Payable, Prepaid Insurance, Supplies, Supplies Expense, Utilities Expense, and Utilities Payable.

Prepare adjusting entries.

E3.10 (LO 2, 3) The trial balance for Yazici Advertising A.Ş. is shown in Illustration 3.4. Instead of the adjusting entries shown in the text at October 31, assume the following adjustment data.

1. Supplies on hand at October 31 total ₺500.
2. Expired insurance for the month is ₺120.
3. Depreciation for the month is ₺50.
4. Services related to unearned service revenue in October worth ₺600 were performed.
5. Services performed but not recorded at October 31 are ₺360.
6. Interest accrued at October 31 is ₺95.

7. Accrued salaries at October 31 are Ł1,625.

Instructions

Prepare the adjusting entries for the items above.

Prepare correct income statement.

E3.11 (LO 1, 2, 3, 4) The income statement of Bjorn ASA for the month of July shows net income of €1,400 based on Service Revenue €5,500, Salaries and Wages Expense €2,300, Supplies Expense €1,200, and Utilities Expense €600. In reviewing the statement, you discover the following.

1. Insurance expired during July of €500 was omitted.
2. Supplies expense includes €250 of supplies that are still on hand at July 31.
3. Depreciation on equipment of €150 was omitted.
4. Accrued but unpaid salaries and wages at July 31 of €400 were not included.
5. Services performed but unrecorded totaled €650.

Instructions

Prepare a correct income statement for July 2025.

Analyze adjusted data.

E3.12 (LO 1, 2, 3, 4) A partial adjusted trial balance of Rooney Sports at January 31, 2025, shows the following.

Rooney Sports
Adjusted Trial Balance
January 31, 2025

	Debit	Credit
Supplies	£ 850	
Prepaid Insurance	2,400	
Salaries and Wages Payable		£ 920
Unearned Service Revenue		750
Supplies Expense	950	
Insurance Expense	400	
Salaries and Wages Expense	2,900	
Service Revenue		2,000

Instructions

Answer the following questions, assuming the year begins January 1.

a. If the amount in Supplies Expense is the January 31 adjusting entry and £1,000 of supplies was purchased in January, what was the balance in Supplies on January 1?

b. If the amount in Insurance Expense is the January 31 adjusting entry and the original insurance premium was for one year, what was the total premium and when was the policy purchased?

c. If £3,800 of salaries was paid in January, what was the balance in Salaries and Wages Payable at December 31, 2024?

Journalize basic transactions and adjusting entries.

E3.13 (LO 2, 3) Selected accounts of Al-Kazaz Interiors are shown as follows.

Supplies Expense

7/31	900

Supplies

7/1 Bal.	1,100	7/31	900
7/10	650		

Salaries and Wages Payable

		7/31	1,200

Accounts Receivable

7/31	500		

Unearned Service Revenue

7/31	1,150	7/1 Bal.	1,500
		7/20	1,000

Salaries and Wages Expense

7/15	1,200		
7/31	1,200		

Service Revenue

		7/14	2,200
		7/31	1,150
		7/31	500

Instructions

After analyzing the accounts, journalize (a) the July transactions and (b) the adjusting entries that were made on July 31. (*Hint:* July transactions were for cash.)

Prepare adjusting entries from selected account data.

E3.14 (LO 2, 3) The ledger of Yoon Lumber Supply on July 31, 2025, includes the selected accounts below before adjusting entries have been prepared.

	Debit	Credit
Notes Payable		₩ 20,000
Supplies	₩ 24,000	
Prepaid Rent	3,600	
Buildings	250,000	
Accumulated Depreciation—Buildings		140,000
Unearned Service Revenue		11,500

An analysis of the company's accounts shows the following.

1. The notes payable pay interest at a rate of 6% per year.
2. Supplies on hand at the end of the month totaled ₩18,600.
3. The balance in Prepaid Rent represents 4 months of rent costs.
4. Employees were owed ₩3,100 related to unpaid salaries and wages.
5. Depreciation on buildings is ₩6,000 per year.
6. During the month, the company satisfied obligations worth ₩4,700 related to the Unearned Services Revenue.
7. Unpaid maintenance and repairs costs were ₩2,300.

Instructions

Prepare the adjusting entries at July 31 assuming that adjusting entries are made monthly. Use additional accounts as needed.

Determine effect of adjusting entries.

E3.15 (LO 2, 3) On December 31, 2025, Waters Electricians prepared an income statement and statement of financial position, but failed to take into account three adjusting entries. The statement of financial position showed total assets €150,000, total liabilities €70,000, and equity €80,000. The incorrect income statement showed net income of €70,000.

The data for the three adjusting entries were:

1. Salaries and wages amounting to €10,000 for the last 2 days in December were not paid and not recorded. The next payroll will be in January.
2. Rent payments of €8,000 were received for two months in advance on December 1. The entire amount was credited to Unearned Rent Revenue when paid.
3. Depreciation expense for 2025 is €9,000.

Instructions

Complete the following table to correct the financial statement amounts shown (indicate deductions with parentheses).

Item	Net Income	Total Assets	Total Liabilities	Equity
Incorrect balances	€70,000	€150,000	€70,000	€80,000
Effects of:				
Salaries and Wages	_____	_____	_____	_____
Rent Revenue	_____	_____	_____	_____
Depreciation	_____	_____	_____	_____
Correct balances	_____	_____	_____	_____

Prepare and post transaction and adjusting entries for prepayments.

E3.16 (LO 2) Action Quest Games adjusts its accounts annually. The following information is available for the year ended December 31, 2025.

1. Purchased a 1-year insurance policy on June 1 for $1,800 cash.
2. Paid $6,500 on August 31 for 5 months' rent in advance.
3. On September 4, received $3,600 cash in advance from a company to sponsor a game night each month for a total of 9 months for the most improved students at a local school.
4. Signed a contract for cleaning services starting December 1 for $1,000 per month. Paid for the first 2 months on November 30. (*Hint:* Use the account Prepaid Cleaning to record prepayments.)
5. On December 5, received $1,500 in advance from a gaming club. Determined that on December 31, $475 of these games had not yet been played.

Instructions

a. For each of the above transactions, prepare the journal entry to record the initial transaction.

b. For each of the above transactions, prepare the adjusting journal entry that is required on December 31, (*Hint:* Use the account Service Revenue for item 3 and Maintenance and Repair Expense for item 4.)

c. Post the journal entries in parts (a) and (b) to T-accounts and determine the final balance in each account balance. (*Note:* Posting to the Cash account is not required.)

Prepare adjusting and subsequent entries for accruals.

E3.17 (LO 3) Greenock Company has the following information available for accruals for the year ended December 31, 2025. The company adjusts its accounts annually.

1. The December utility bill for $425 was unrecorded on December 31. Greenock paid the bill on January 11.
2. Greenock is open 7 days a week and employees are paid a total of $3,500 every Monday for a 7-day (Monday–Sunday) workweek. Assume December 31 is a Thursday, so employees will have worked 4 days (Monday, December 28–Thursday, December 31) that they have not been paid for by year-end. Employees will be paid next on January 4.

3. Greenock signed a $48,000, 5% bank loan on November 1, 2025, due in 2 years. No interest payments were made in 2025. Interest for 2025 was paid on January 1, 2026.
4. Greenock receives a fee from Pizza Shop next door for all pizzas sold to customers using Greenock's facility. The amount owed for December is $300, which Pizza Shop will pay on January 4. (*Hint:* Use the Service Revenue account.)
5. Greenock rented some of its unused warehouse space to a client for $6,000 a month, payable the first day of the following month. It received the rent for the month of December on January 2.

Instructions

a. For each situation, prepare the adjusting entry required at December 31. (Round all calculations to the nearest dollar.)

b. For each situation, prepare the journal entry to record the subsequent cash transaction in 2026.

Prepare adjusting entries from analysis of trial balances.

E3.18 (LO 2, 3, 4) The trial balances before and after adjustment for Matusiak OAO at the end of its fiscal year are presented below.

Matusiak OAO
Trial Balance
August 31, 2025

	Before Adjustment		After Adjustment	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Cash	€10,400		€10,400	
Accounts Receivable	8,800		11,200	
Supplies	2,300		700	
Prepaid Insurance	4,000		2,500	
Equipment	14,000		14,000	
Accumulated Depreciation—Equipment		€ 3,600		€ 4,500
Accounts Payable		5,800		5,800
Salaries and Wages Payable		–0–		1,100
Unearned Rent Revenue		1,500		400
Share Capital—Ordinary		12,600		12,600
Retained Earnings		3,000		3,000
Service Revenue		34,000		36,400
Rent Revenue		11,000		12,100
Salaries and Wages Expense	17,000		18,100	
Supplies Expense	–0–		1,600	
Rent Expense	15,000		15,000	
Insurance Expense	–0–		1,500	
Depreciation Expense	–0–		900	
	€71,500	€71,500	€75,900	€75,900

Instructions

Prepare the adjusting entries that were made.

Prepare financial statements from adjusted trial balance.

E3.19 (LO 4) The adjusted trial balance for Matusiak OAO is given in E3.18.

Instructions

Prepare the income and retained earnings statements for the year and the statement of financial position at August 31.

Record transactions on accrual basis; convert revenue to cash receipts.

E3.20 (LO 2, 3) The following data are taken from the comparative statements of financial position of Newman Billiards Club, which prepares its financial statements using the accrual basis of accounting.

December 31	2025	2024
Accounts receivable from members	£16,000	£ 8,000
Unearned service revenue	17,000	25,000

Members are billed based upon their use of the club's facilities. Unearned service revenues arise from the sale of gift certificates, which members can apply to their future use of club facilities. The 2025 income statement for the club showed that service revenue of £161,000 was recognized during the year.

Instructions

(*Hint:* You will probably find it helpful to use T-accounts to analyze these data.)

a. Prepare journal entries for each of the following events that took place during 2025.

1. Accounts receivable from 2024 were all collected.
2. Gift certificates outstanding at the end of 2024 were all redeemed.
3. An additional £38,000 worth of gift certificates were sold during 2025. A portion of these was used by the recipients during the year; the remainder was still outstanding at the end of 2025.
4. Services performed for members for 2025 were billed to members.
5. Accounts receivable for 2025 (i.e., those billed in item [4] above) were partially collected.

b. Determine the amount of cash received by the club, with respect to member services, during 2025.

Journalize adjusting entries.

***E3.21 (LO 5)** Vissar Foods has the following balances in selected accounts on December 31, 2025.

Service Revenue	€40,000
Insurance Expense	2,400
Supplies Expense	2,450

All the accounts have normal balances. Vissar Foods debits prepayments to expense accounts when paid, and credits unearned revenues to revenue accounts when received. The following information below has been gathered at December 31, 2025.

1. Vissar Foods paid €2,400 for 12 months of insurance coverage on June 1, 2025.
2. On December 1, 2025, Vissar collected €40,000 for consulting services to be performed from December 1, 2025, through March 31, 2026.
3. A count of supplies on December 31, 2025, indicates that supplies of €600 are on hand.

Instructions

Prepare the annual adjusting entries needed at December 31, 2025.

Journalize transactions and adjusting entries.

***E3.22 (LO 5)** At Moretti Automotive, prepayments are debited to expense when paid, and unearned revenues are credited to revenue when cash is received. During January of the current year, the following transactions occurred.

Jan.	2	Paid €1,920 for fire insurance protection for the year.
	10	Paid €1,700 for supplies.
	15	Received €6,100 for services to be performed in the future.

On January 31, it is determined that €2,100 of the services were performed and that there are €650 of supplies on hand.

Instructions

a. Journalize and post the January transactions. (Use T-accounts.)

b. Journalize and post the adjusting entries at January 31.

c. Determine the ending balance in each of the accounts.

Identify accounting assumptions and principles.

***E3.23 (LO 6)** Presented below are the assumptions and principles discussed in Appendix 3B.

1. Full disclosure principle.
2. Going concern assumption.
3. Monetary unit assumption.
4. Time period assumption.
5. Historical cost basis.
6. Economic entity assumption.

Instructions

Identify by number the accounting assumption or basis that is described below. Do not use a number more than once.

_____ **a.** Is the rationale for why plant assets are not reported at liquidation value. (*Note:* Do not use the historical cost basis.)

_____ **b.** Indicates that personal and business recordkeeping should be separately maintained.

_____ **c.** Assumes that the monetary unit is the "measuring stick" used to report on financial performance.

_____ **d.** Separates financial information into time periods for reporting purposes.

_____ **e.** Measurement basis used when a reliable estimate of current value is not available.

_____ **f.** Dictates that companies should disclose all circumstances and events that make a difference to financial statement users.

Identify the assumption or principle that has been violated.

***E3.24 (LO 6)** Weber Co. had three major business transactions during 2025.

a. Reported at its current value of $260,000 merchandise inventory with a cost of $208,000 (in Canadian dollars).

b. The president of Weber Co., Austin Weber, purchased a truck for personal use and charged it to his expense account.

c. Weber Co. wanted to make its 2025 income look better, so it added 2 more weeks to the year (a 54-week year). Previous years were 52 weeks.

Instructions

In each situation, identify the assumption or principle that has been violated, if any, and discuss what the company should have done.

Identity financial accounting concepts and principles.

***E3.25 (LO 6)** The following characteristics, assumptions, principles, or constraint guide the IASB when it creates accounting standards.

Relevance	Expense recognition principle
Faithful representation	Time period assumption
Comparability	Going concern assumption
Consistency	Historical cost basis
Monetary unit assumption	Full disclosure principle
Economic entity assumption	Materiality

Match each item above with a description below.

1. _____ Ability to easily evaluate one company's results relative to another's.
2. _____ Assumption that a company will continue to operate for the foreseeable future.
3. _____ The judgment concerning whether an item's size is large enough to matter to decision-makers.
4. _____ The reporting of all information that would make a difference to financial statement users.
5. _____ The practice of preparing financial statements at regular intervals.
6. _____ The quality of information that indicates the information makes a difference in a decision.
7. _____ A belief that items should be reported on the statement of financial position at the price that was paid to acquire them.
8. _____ A company's use of the same accounting principles and methods from year to year.
9. _____ Tracing accounting events to particular companies.
10. _____ The desire to minimize bias in financial statements.
11. _____ Reporting only those things that can be measured in monetary units.
12. _____ Dictates that efforts (expenses) be recognized in the period in which a company generates results (revenues).

Comment on the objective and qualitative characteristics of accounting information.

***E3.26 (LO 6)** **Writing** Speyeware International, headquartered in Vancouver, Canada, specializes in Internet safety and computer security products for both the home and commercial markets. In a recent statement of financial position, it reported a deficit of US$5,678,288. It has reported only net losses since its inception. In spite of these losses, Speyeware's shares have traded anywhere from a high of $3.70 to a low of $0.32 on the Canadian Venture Exchange (in Canadian dollars).

Speyeware's financial statements have historically been prepared in Canadian dollars. Recently, the company adopted the U.S. dollar as its reporting currency.

Instructions

a. What is the objective of financial reporting? How does this objective meet or not meet Speyeware's investors' needs?

b. Why would investors want to buy Speyeware's shares if the company has consistently reported losses over the last few years? Include in your answer an assessment of the relevance of the information reported on Speyeware's financial statements.

c. Comment on how the change in reporting information from Canadian dollars to U.S. dollars likely affected the readers of Speyeware's financial statements. Include in your answer an assessment of the comparability of the information.

Comment on the objective and qualitative characteristics of financial reporting.

***E3.27 (LO 6)** **Writing** A friend of yours, Mindy Gare, recently completed an undergraduate degree in science and has just started working with a biotechnology company. Mindy tells you that the company is trying to secure new sources of financing in order to proceed with the development of a new healthcare product. Mindy said that her boss told her that the company must put together a report to present to potential investors.

Mindy thought that the company should include in this package the detailed scientific findings related to the Phase I clinical trials for this product. She said, "I know that the biotech industry sometimes has only a 10% success rate with new products, but if we report all the scientific findings, everyone will see what a sure success this is going to be! The president was talking about the importance of following some set of accounting principles. Why do we need to look at some accounting rules? What they need to realize is that we have scientific results that are quite encouraging, some of the most talented employees around, and the start of some really great customer relationships. We haven't made any sales yet, but we will. We just need the funds to get through all the clinical testing and get government approval for our product. Then these investors will be quite happy that they bought in to our company early!"

Instructions

a. What is accounting information?

b. Comment on how Mindy's suggestions for what should be reported to prospective investors conforms to the qualitative characteristics of accounting information. Do you think that the things that Mindy wants to include in the information for investors will conform to financial reporting guidelines?

Problems

Prepare adjusting entries, post to ledger accounts, and prepare an adjusted trial balance.

P3.1 (LO 2, 3, 4) Sadie Cuono started her own consulting firm, Cuono Consulting, on May 1, 2025. The trial balance at May 31 is as follows.

Cuono Consulting
Trial Balance
May 31, 2025

Account Number		Debit	Credit
101	Cash	€ 4,500	
112	Accounts Receivable	6,000	
126	Supplies	1,900	
130	Prepaid Insurance	3,600	
149	Equipment	11,400	
201	Accounts Payable		€ 4,500
209	Unearned Service Revenue		2,000
311	Share Capital—Ordinary		18,700
400	Service Revenue		9,500
726	Salaries and Wages Expense	6,400	
729	Rent Expense	900	
		€34,700	€34,700

In addition to those accounts listed on the trial balance, the chart of accounts for Cuono Consulting also contains the following accounts and account numbers: No. 150 Accumulated Depreciation—Equipment, No. 212 Salaries and Wages Payable, No. 631 Supplies Expense, No. 717 Depreciation Expense, No. 722 Insurance Expense, and No. 732 Utilities Expense.

Other data:

1. €900 of supplies have been used during the month.
2. Utilities expense incurred but not paid on May 31, 2025, €250.
3. The insurance policy is for 2 years.
4. €400 of the balance in the unearned service revenue account remains unearned at the end of the month.
5. Assume May 31 is a Wednesday, and employees are paid on Fridays. Cuono Consulting has two employees, who are paid €920 each for a 5-day work week.

6. The office furniture has a 5-year life with no residual value. It is being depreciated at €190 per month for 60 months.
7. Invoices representing €1,700 of services performed during the month have not been recorded as of May 31.

Instructions

a. Prepare the adjusting entries for the month of May. Use J4 as the page number for your journal.

b. Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances and place a check mark in the posting reference column.

c. Prepare an adjusted trial balance at May 31, 2025.

c. Adj. trial balance €37,944

Prepare adjusting entries, post, and prepare adjusted trial balance and financial statements.

P3.2 (LO 2, 3, 4) Lazy River Resort opened for business on May 1, 2025. Its trial balance before adjustment on May 31 is as follows.

Lazy River Resort
Trial Balance
May 31, 2025

Account Number		Debit	Credit
101	Cash	€ 3,400	
126	Supplies	2,080	
130	Prepaid Insurance	2,400	
140	Land	12,000	
141	Buildings	60,000	
149	Equipment	14,000	
201	Accounts Payable		€ 4,700
208	Unearned Rent Revenue		3,300
275	Mortgage Payable		40,000
311	Share Capital—Ordinary		41,380
332	Dividends	1,000	
429	Rent Revenue		10,300
610	Advertising Expense	600	
726	Salaries and Wages Expense	3,300	
732	Utilities Expense	900	
		€99,680	€99,680

In addition to those accounts listed on the trial balance, the chart of accounts for Lazy River Resort also contains the following accounts and account numbers: No. 142 Accumulated Depreciation—Buildings, No. 150 Accumulated Depreciation—Equipment, No. 212 Salaries and Wages Payable, No. 230 Interest Payable, No. 619 Depreciation Expense, No. 631 Supplies Expense, No. 718 Interest Expense, and No. 722 Insurance Expense.

Other data:

1. Prepaid insurance is a 1-year policy starting May 1, 2025.
2. A count of supplies shows €750 of unused supplies on May 31.
3. Annual depreciation is €3,600 on the buildings and €1,500 on equipment.
4. The mortgage interest rate is 6%. (The mortgage was taken out on May 1.)
5. Two-thirds of the unearned rent revenue is recognized as revenue.

6. Salaries of €750 are accrued and unpaid at May 31.

Instructions

a. Journalize the adjusting entries on May 31.

b. Prepare a ledger using the three-column form of account. Enter the trial balance amounts and post the adjusting entries. (Use J1 as the posting reference.)

c. Prepare an adjusted trial balance on May 31.

c. Adj. trial balance €101,055

d. Prepare an income statement and a retained earnings statement for the month of May and a statement of financial position at May 31.

d. Net income €4,795

Ending retained earnings €3,795

Total assets €91,925

Prepare adjusting entries and financial statements.

P3.3 (LO 2, 3, 4) Alena Co. was organized on July 1, 2025. Quarterly financial statements are prepared. The unadjusted and adjusted trial balances as of September 30 are shown below.

Alena Co.
Trial Balance
September 30, 2025

	Unadjusted		Adjusted	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Cash	$ 8,700		$ 8,700	
Accounts Receivable	10,400		11,500	
Supplies	1,500		650	
Prepaid Rent	2,200		500	
Equipment	18,000		18,000	
Accumulated Depreciation—Equipment		$ –0–		$ 700
Notes Payable		10,000		10,000
Accounts Payable		2,500		2,500
Salaries and Wages Payable		–0–		725
Interest Payable		–0–		100
Unearned Rent Revenue		1,900		450
Share Capital—Ordinary		22,000		22,000
Dividends	1,600		1,600	
Service Revenue		16,000		17,100
Rent Revenue		1,410		2,860
Salaries and Wages Expense	8,000		8,725	
Rent Expense	1,900		3,600	
Depreciation Expense			700	
Supplies Expense			850	
Utilities Expense	1,510		1,510	
Interest Expense			100	
	$53,810	$53,810	$56,435	$56,435

Instructions

a. Journalize the adjusting entries that were made.

b. Prepare an income statement and a retained earnings statement for the 3 months ending September 30 and a statement of financial position at September 30.

b. Net income $4,475

Ending retained earnings $2,875

Total assets $38,650

c. If the note bears interest at 12%, how many months has it been outstanding?

Prepare adjusting entries.

P3.4 (LO 2, 3) A review of the ledger of Bellingham Accountants at December 31, 2025, produces the following data pertaining to the preparation of annual adjusting entries.

1. Prepaid Insurance €10,340. The company has separate insurance policies on its buildings and its motor vehicles. Policy B4564 on the building was purchased on April 1, 2024, for €7,920. The policy has a term of 3 years. Policy A2958 on the vehicles was purchased on January 1, 2025, for €4,400. This policy has a term of 2 years.

   1. Insurance expense €4,840

2. Unearned Rent Revenue €378,000. The company began subleasing office space in its new building on November 1. At December 31, the company had the following rental contracts that are paid in full for the entire term of the lease.

Date	Term (in months)	Monthly Rent	Number of Leases
Nov. 1	9	€5,000	5
Dec. 1	6	€8,500	3

   2. Rent revenue €75,500

3. Notes Payable €120,000. This balance consists of a note for 9 months at an annual interest rate of 6%, dated November 1.

   3. Interest expense €1,200

4. Salaries and Wages Payable €0. There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of €700 each per week, and three employees earn €500 each per week. Assume December 31 is a Tuesday. Employees do not work weekends. All employees worked the last 2 days of December.

   4. Salaries and wages expense €2,000

Instructions

Prepare the adjusting entries at December 31, 2025.

Journalize transactions and follow through accounting cycle to preparation of financial statements.

P3.5 (LO 2, 3, 4) On November 1, 2025, the account balances of Beck Equipment Repair were as follows.

No.		Debit	No.		Credit
101	Cash	£ 2,400	154	Accumulated Depreciation—Equipment	£ 2,000
112	Accounts Receivable	4,250	201	Accounts Payable	2,600
126	Supplies	1,800	209	Unearned Service Revenue	1,200
153	Equipment	12,000	212	Salaries and Wages Payable	700
			311	Share Capital—Ordinary	11,000
			320	Retained Earnings	2,950
		£20,450			£20,450

During November, the following summary transactions were completed.

Nov.	8	Paid £1,700 for salaries due employees, of which £700 is for October salaries.
	10	Received £3,620 cash from customers on account.
	12	Received £3,100 cash for services performed in November.
	15	Purchased equipment on account £2,000.
	17	Purchased supplies on account £700.
	20	Paid creditors on account £2,700.
	22	Paid November rent £400.
	25	Paid salaries £1,700.
	27	Performed services on account and billed customers for these services £2,200.
	29	Received £600 from customers for future service.

Adjustment data consist of:

1. Supplies on hand £1,400.
2. Accrued salaries payable £350.
3. Depreciation for the month is £200.
4. Services related to unearned service revenue of £1,220 were performed.

Instructions

a. Enter the November 1 balances in the ledger accounts.

b. Journalize the November transactions.

c. Post to the ledger accounts. Use J1 for the posting reference. Use the following additional accounts: No. 407 Service Revenue, No. 615 Depreciation Expense, No. 631 Supplies Expense, No. 726 Salaries and Wages Expense, and No. 729 Rent Expense.

d. Prepare a trial balance at November 30.

d. Trial balance £25,650

e. Journalize and post adjusting entries.

f. Prepare an adjusted trial balance.

f. Adj. trial balance £26,200

g. Prepare an income statement and a retained earnings statement for November and a statement of financial position at November 30.

g. Net income £1,770;

Ending retained earnings £4,720

Total assets £19,250

Prepare adjusting entries, adjusted trial balance, and financial statements using appendix.

***P3.6 (LO 2, 3, 4, 5)** Alpha's Graphics was organized on January 1, 2025, by Gabriel Alpha. At the end of the first 6 months of operations, the trial balance contained the following accounts.

	Debit		Credit
Cash	€ 8,600	Notes Payable	€ 20,000
Accounts Receivable	14,000	Accounts Payable	9,000
Equipment	45,000	Share Capital—Ordinary	22,000
Insurance Expense	2,700	Service Revenue	58,100
Salaries and Wages Expense	30,000		
Supplies Expense	3,700		
Advertising Expense	1,900		
Rent Expense	1,500		
Utilities Expense	1,700		
	€109,100		€109,100

Analysis reveals the following additional data.

1. The €3,700 balance in Supplies Expense represents supplies purchased in January. At June 30, €1,300 of supplies are on hand.
2. The note payable was issued on February 1. It is a 6%, 6-month note.
3. The balance in Insurance Expense is the premium on a one-year policy, dated April 1, 2025.
4. Service revenues are credited to revenue when received. At June 30, services revenue of €1,300 are unearned.
5. Revenue for services performed but unrecorded at June 30 totals €2,000.
6. Depreciation is €2,250 per year.

Instructions

a. Journalize the adjusting entries at June 30. (Assume adjustments are recorded every 6 months.)

b. Prepare an adjusted trial balance.

b. Adj. trial balance €112,725

c. Prepare an income statement and retained earnings statement for the 6 months ended June 30 and a statement of financial position at June 30.

c. Net income €19,000

Ending retained earnings €19,000

Total assets €71,800

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT3.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

a. Using the consolidated financial statements and related information, identify items that may result in adjusting entries for prepayments.

b. Using the consolidated financial statements and related information, identify items that may result in adjusting entries for accruals.

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT3.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C. For Delphi, use the information in "The Group" columns.

Instructions

Based on information contained in these financial statements, determine the following for each company.

a. Net increase (decrease) in property, plant, and equipment (net) for the most recent fiscal year shown.

b. Increase (decrease) in marketing and administration expenses (Nestlé) and increase (decrease) in selling, distribution, and administrative expenses (Delfi) for the most recent fiscal year shown.

c. Increase (decrease) in non-current liabilities for the most recent fiscal year shown.

d. Increase (decrease) in profit for the most recent fiscal year shown.

e. Increase (decrease) in cash and cash equivalents for the most recent fiscal year shown.

Decision-Making Across the Organization

CT3.3 Happy Trails Park was organized on April 1, 2024, by Alicia Henry. Alicia is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Alicia prepared the following income statement for the quarter that ended March 31, 2025.

Happy Trails Park
Income Statement
For the Quarter Ended March 31, 2025

Revenues		
Rent revenue		£88,000
Operating expenses		
Advertising	£ 5,200	
Salaries and wages	28,800	
Utilities	750	
Depreciation	800	
Maintenance and repairs	4,000	
Total operating expenses		39,550
Net income		£48,450

Alicia thought that something was wrong with the statement because net income had never exceeded £20,000 in any one quarter. Knowing that you are an experienced accountant, she asks you to review the income statement and other data.

You first look at the trial balance. In addition to the account balances reported above in the income statement, the ledger contains the following additional selected balances at March 31, 2025.

Supplies	£ 6,200
Prepaid Insurance	7,500
Notes Payable	12,000

You then make inquiries and discover the following.

1. Rent revenue includes advanced rentals for summer occupancy £14,000.
2. There were £1,450 of supplies on hand at March 31.
3. Prepaid insurance resulted from the payment of a 1-year policy on January 1, 2025.
4. The mail on April 1, 2025, brought the following bills: advertising for week of March 24, £130; repairs made March 10, £260; and utilities, £120.
5. There are four employees, who receive wages totaling £300 per day. At March 31, 2 days' salaries and wages have been incurred but not paid.
6. The note payable is a 3-month, 10% note dated January 1, 2025.

Instructions

With the class divided into groups, answer the following.

a. Prepare a correct income statement for the quarter ended March 31, 2025.

b. Explain to Alicia the IFRSs that she did not follow in preparing her income statement and their effect on her results.

Communication Activity

CT3.4 In reviewing the accounts of Maribeth Ltd. at the end of the year, you discover that adjusting entries have not been made.

Instructions

Write an email to Maribeth Danon, the owner of Maribeth Ltd., that explains the following: the nature and purpose of adjusting entries, why adjusting entries are needed, and the types of adjusting entries that may be made.

Ethics Case

CT3.5 Watkin Exterminators is a pesticide manufacturer. Its sales declined greatly this year due to the passage of legislation outlawing the sale of several of Watkin's chemical pesticides. In the coming year, Watkin will have environmentally safe and competitive chemicals to replace these discontinued products. Sales in the next year are expected to greatly exceed any prior years. The decline in sales and profits appears to be a 1-year aberration. But even so, the company's president fears a large dip in the current year's profits. He believes that such a dip could cause a significant drop in the market price of Watkin's ordinary shares and make the company a takeover target.

To avoid this possibility, the company's president calls in Diane Leno, controller, to discuss this period's year-end adjusting entries. He urges her to accrue every possible revenue and to defer as many expenses as possible. He says to Diane, "We need the revenues this year, and next year can easily absorb expenses deferred from this year. We can't let our share price be hammered down!" Diane didn't get around to recording the adjusting entries until January 17, but she dated the entries December 31 as if they were recorded then. Diane also made every effort to comply with the president's request.

Instructions

a. Who are the stakeholders in this situation?

b. What are the ethical considerations of (1) the president's request and (2) Diane's dating the adjusting entries December 31?

c. Can Diane accrue revenues and defer expenses and still be ethical?

A Look at U.S. GAAP

LEARNING OBJECTIVE 7

Compare the procedures for adjusting entries under IFRS and U.S. GAAP.

Measuring income, including the measurement of revenues and expenses in a manner that faithfully represents the economic activities of a business in a reliable manner, is a challenging task. Both the IASB and FASB have established and continue to develop their conceptual frameworks that will enable companies to better use the same principles to record transactions consistently over time. The objective of the conceptual framework project is to lead to standards that are more principles-based and internally consistent, which in turn will lead to the most useful financial reporting information.

Key Points

- As indicated above, both the IASB and FASB have established and are continuing to develop conceptual frameworks. Both frameworks are designed to address a common set of issues including the following.
  - What is the primary objective of financial reporting?
  - What are the qualitative characteristics that make accounting information useful?
  - What are the elements that make up the financial statements?
  - What basis should be used to measure and report, that is, should a historical cost or current value approach be used?

  - What criteria should be used to determine when revenue should be recognized and when expenses have been incurred?
  - What guidelines should be established for disclosing financial information?
- While the IASB and the FASB were working for a period of time to converge their conceptual frameworks, that project has become inactive.

Similarities

- Like IFRS, companies applying GAAP use accrual-basis accounting to ensure that they record transactions that change a company's financial statements in the period in which events occur.
- Similar to IFRS, cash-basis accounting is not in accordance with GAAP.
- GAAP also divides the economic life of companies into artificial time periods. Under both GAAP and IFRS, this is referred to as the *time period assumption*. GAAP requires that companies present a complete set of financial statements, including comparative information annually.
- The form and content of financial statements are very similar under GAAP and IFRS. Any significant differences will be discussed in those chapters that address specific financial statements.
- Revenue recognition fraud is a major issue in U.S. financial reporting. The same situation exists for most other countries as well.

Differences

- Prior to the issuance of a new joint revenue recognition standard by the IASB and the FASB, GAAP had more than 100 rules dealing with revenue recognition. Many of these rules were industry-specific. Revenue recognition under IFRS was determined primarily by a single standard, *IAS 18*. Despite this large disparity in the detailed guidance devoted to revenue recognition, the **general** revenue recognition principles required by IFRS were similar to those under GAAP.
- Internal controls are a system of checks and balances designed to detect and prevent fraud and errors. The Sarbanes-Oxley Act requires U.S. companies to enhance their systems of internal control. However, many foreign companies do not have this requirement.
- Under IFRS, revaluation to current value of items such as land and buildings is permitted. This is not permitted under GAAP.
- Under IFRS, the term "income" includes *both* revenues, which arise during the normal course of operating activities, and gains, which arise from activities outside of the normal sales of goods and services. The term income is not used this way under GAAP. Instead, under GAAP income refers to the net difference between revenues and expenses. Expenses under IFRS include both those costs incurred in the normal course of operations, as well as losses that are not part of normal operations. This is in contrast to GAAP, which defines each separately.

GAAP Practice

GAAP Self-Test Questions

1. GAAP:

   a. provides the same type of guidance as IFRS for revenue recognition.

   b. provides only general guidance on revenue recognition, compared to the detailed guidance provided by IFRS.

   c. allows revenue to be recognized when a customer makes an order.

   d. requires that revenue not be recognized until cash is received.

Answer

2. Which of the following statements is **false**?

   a. GAAP employs the time period assumption.

   b. GAAP employs accrual accounting.

   c. GAAP requires that revenues and costs must be capable of being measured reliably.

d. GAAP uses the cash basis of accounting.

Answer

3. As a result of the revenue recognition project by the FASB and IASB:

a. revenue recognition places more emphasis on when the performance obligation is satisfied.

b. revenue recognition places more emphasis on when revenue is realized.

c. revenue recognition places more emphasis on when changes occur in related expenses.

d. revenue is no longer recorded unless cash has been received.

Answer

4. Which of the following is **false**?

a. Under IFRS, the term *income* describes both revenues and gains.

b. Under IFRS, the term *expenses* includes losses.

c. Under IFRS, firms do not engage in the closing process.

d. Previously, IFRS had fewer standards than GAAP that addressed revenue recognition.

Answer

5. Accrual-basis accounting:

a. is optional under GAAP.

b. results in companies recording transactions that change a company's financial statements in the period in which events occur.

c. has been eliminated as a result of the IASB/FASB joint project on revenue recognition.

d. is not consistent with the GAAP conceptual framework.

Answer

GAAP Exercises

GAAP3.1 Why might IFRS revalue land and buildings whereas under GAAP this practice is not permissible?

GAAP3.2 Under GAAP, do the definitions of revenues and expenses include gains and losses? Explain.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP3.3 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Visit Apple's company website and answer the following questions from its annual report.

a. Using the financial statements and related information, identify items that may result in adjusting entries for prepayments.

b. Using the financial statements and related information, identify items that may result in adjusting entries for accruals.

Note

1 This example focuses only on the alternative treatment of unearned revenues. For simplicity, we have ignored the entries to Service Revenue pertaining to the immediate recognition of revenue (₺10,000) and the adjusting entry for accrued revenue (₺200).

CHAPTER 4
Completing the Accounting Cycle



Oliver Burston/Ikon Images/Media Bakery

Chapter Preview

Financial statements help employees understand what is happening in the business. In Chapter 3, we prepared financial statements directly from the adjusted trial balance. However, with so many details involved in the end-of-period accounting procedures, it is easy to make errors. One way to minimize errors in the records and to simplify the end-of-period procedures is to use a worksheet.

In this chapter, we will explain the role of the worksheet in accounting. We also will study the remaining steps in the accounting cycle, especially the closing process, again using Yazici Advertising A.Ş. as an example. Then, we will consider correcting entries and classified statements of financial position.

Feature Story

Speaking the Same Language

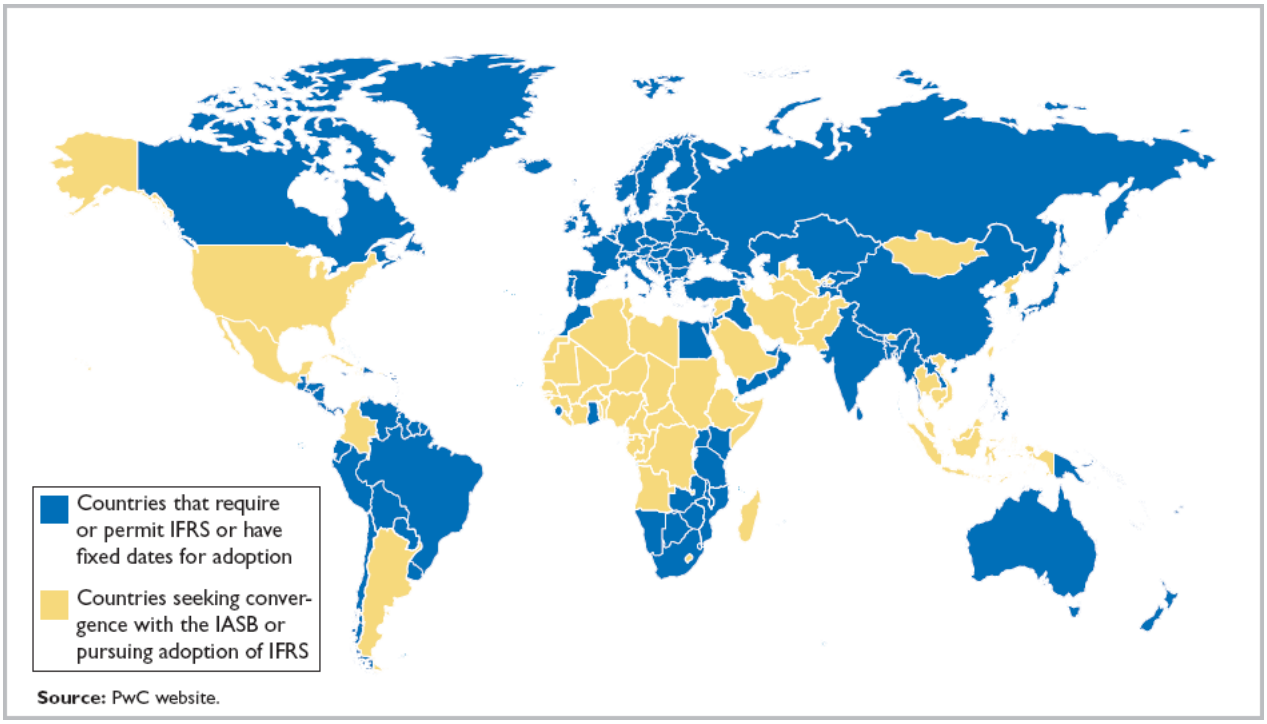
Recent events in the global capital markets underscore the importance of financial disclosure and transparency in markets around the world. As a result, many countries are examining their accounting and financial disclosure rules. As indicated in the following graphic, financial regulators in over 150 countries now use the IFRSs issued by the International Accounting Standards Board (IASB).

What are the potential benefits of having countries use similar standards to prepare their financial statements? One benefit is that investors can compare the results of competing companies from different countries. A second benefit is it enhances efforts to finance growth. Companies (particularly in developing and emerging nations) need to raise funds from outside their borders. Companies that use IFRS gain credibility in the marketplace, which reduces financing costs.

The IASB's stated objectives are as follows.

- To develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB.
- To promote the use and rigorous application of those standards.
- To take account of the financial reporting needs of emerging economies and small- and medium-sized entities (SMEs).
- To bring about convergence of national accounting standards and IFRSs to high-quality solutions.

Accounting standards may never be absolutely identical around the world. However, financial statement users have already benefitted from the increased comparability that has resulted from efforts to minimize differences in accounting standards.



Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Prepare a worksheet.	• Steps in preparing a worksheet • Preparing financial statements from a worksheet • Preparing adjusting entries from a worksheet	DO IT! 1 Worksheet
LO 2 Prepare closing entries and a post-closing trial balance.	• Preparing closing entries • Posting closing entries • Preparing a post-closing trial balance	DO IT! 2 Closing Entries
LO 3 Explain the steps in the accounting cycle and how to prepare correcting entries.	• Summary of the accounting cycle • Reversing entries • Correcting entries	DO IT! 3 Correcting Entries
LO 4 Identify the sections of a classified statement of financial position.	• Intangible assets • Property, plant, and equipment • Long-term investments • Current assets • Equity • Non-current liabilities • Current liabilities	DO IT! 4 Statement of Financial Position Classifications

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

4.1 The Worksheet

LEARNING OBJECTIVE 1

Prepare a worksheet.

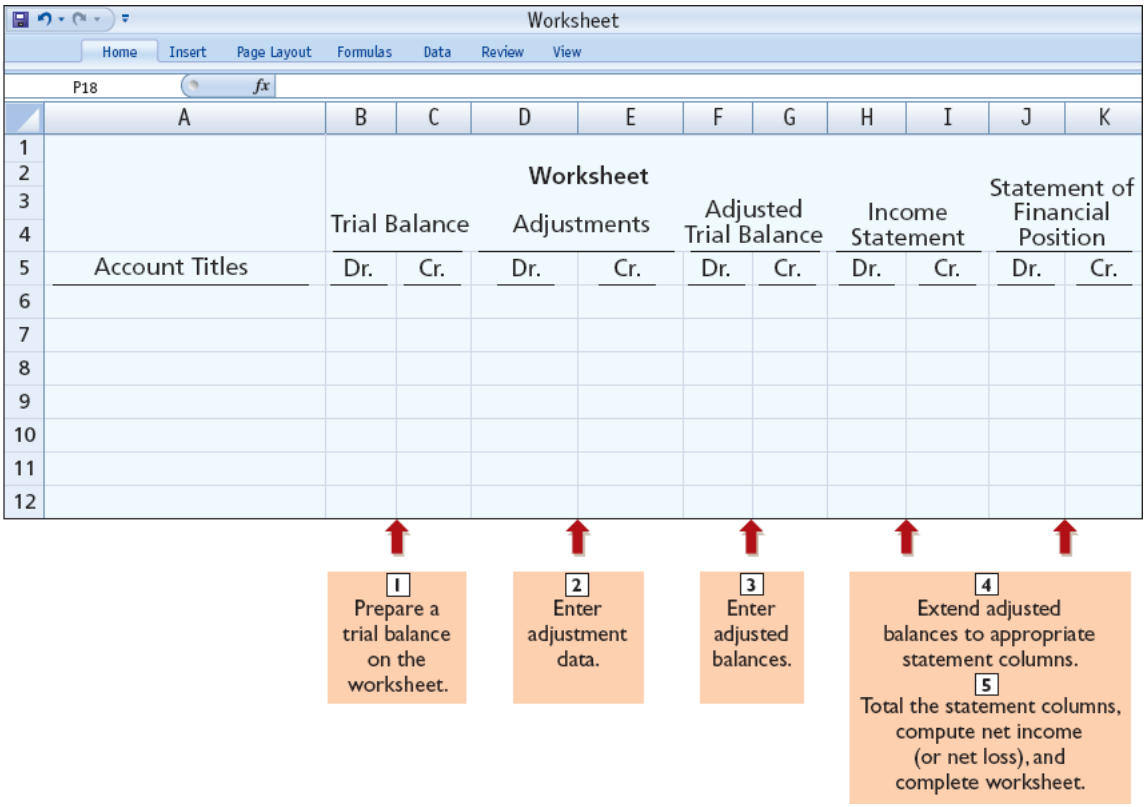
A worksheet is a multiple-column form used in the adjustment process and in preparing financial statements. As its name suggests, the worksheet is a working tool. **It is not a permanent accounting record.** It is neither a journal nor a part of the general ledger. The worksheet is merely a device used in preparing adjusting entries and the financial statements. Companies generally computerize worksheets using an electronic spreadsheet program such as **Microsoft** Excel.

Illustration 4.1 shows the basic form of a worksheet and the five steps for preparing it. Each step is performed in sequence.

- **The use of a worksheet is optional.**
- When a company chooses to use one, it prepares financial statements directly from the worksheet.
- It enters the adjustments in the worksheet columns and then journalizes and posts the adjustments after it has prepared the financial statements.

Thus, worksheets make it possible to provide the financial statements to management and other interested parties at an earlier date.

ILLUSTRATION 4.1 Form and procedure for a worksheet



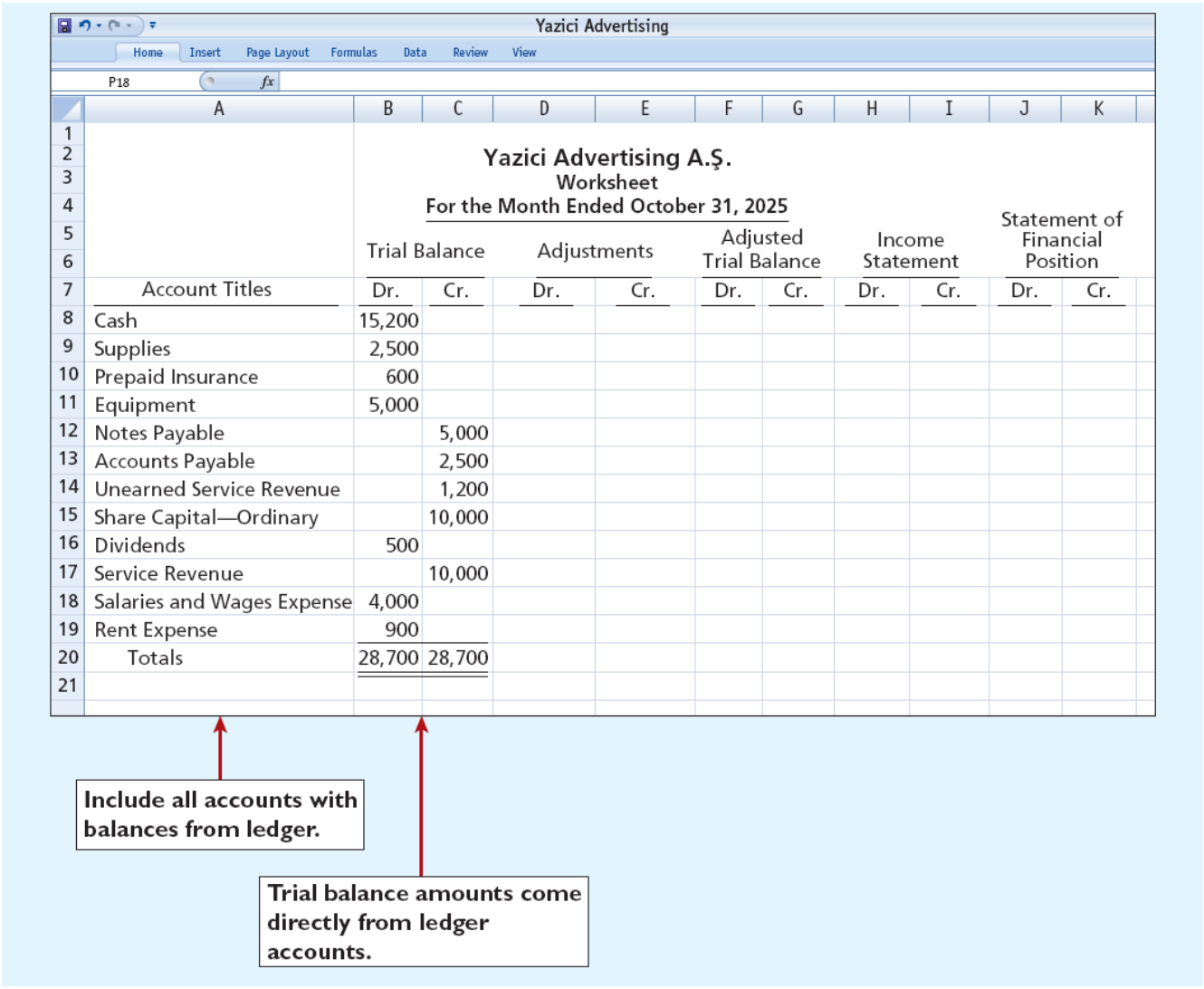
Steps in Preparing a Worksheet

We will use the October 31 trial balance and adjustment data of Yazici Advertising A.Ş. from Chapter 3 to illustrate how to prepare a worksheet. In the following pages, we describe and then demonstrate each step of the process.

Step 1 Prepare a Trial Balance on the Worksheet

The first step in preparing a worksheet is to enter all ledger accounts with balances in the account titles column and then enter debit and credit amounts from the ledger in the trial balance columns. **Illustration 4.2** shows the worksheet trial balance for Yazici Advertising. This trial balance is the same one that appears in Illustration 2.32 and Illustration 3.4.

ILLUSTRATION 4.2 **Preparing a trial balance**



Step 2 Enter the Adjustments in the Adjustments Columns

As shown in **Illustration 4.3**, the second step when using a worksheet is to enter all adjustments in the adjustments columns. In entering the adjustments, use applicable trial balance accounts. If additional accounts are needed, insert them on the lines immediately below the trial balance totals. A different letter identifies the debit and credit for each adjusting entry. The term used to describe this process is **keying**. **Companies do not journalize the adjustments until after they complete the worksheet and prepare the financial statements.**

The adjustments for Yazici Advertising are the same as the adjustments in Illustration 3.24. They are keyed in the adjustments columns of the worksheet as follows.

a. Yazici debits an additional account, Supplies Expense, ₺1,500 for the cost of supplies used, and credits Supplies ₺1,500.

b. Yazici debits an additional account, Insurance Expense, ₺50 for the insurance that has expired, and credits Prepaid Insurance ₺50.

c. The company needs two additional depreciation accounts. It debits Depreciation Expense ₺40 for the month's depreciation, and credits Accumulated Depreciation—Equipment ₺40.

d. Yazici debits Unearned Service Revenue ₺400 for services performed, and credits Service Revenue ₺400.

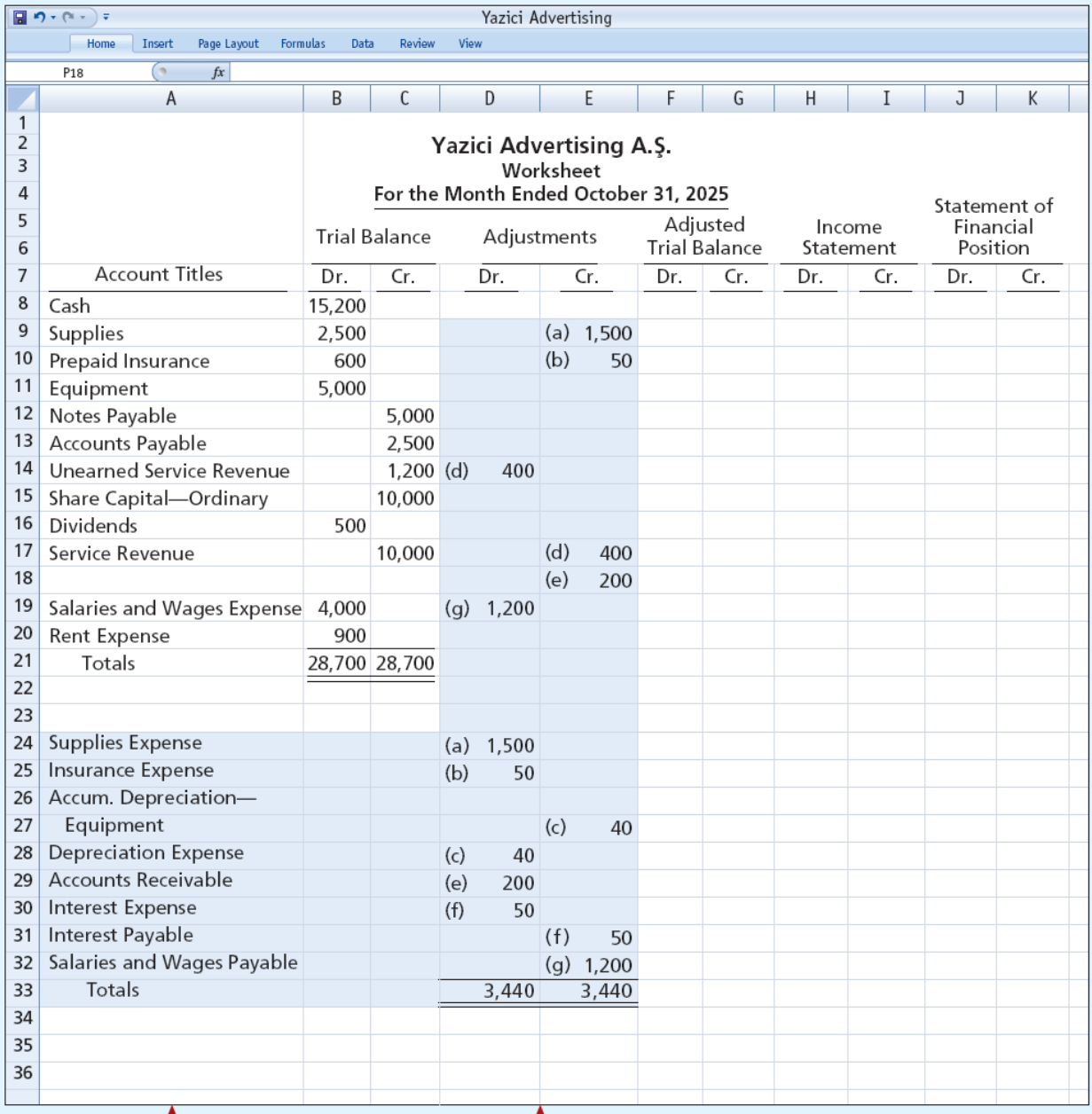
e. Yazici debits an additional account, Accounts Receivable, ₺200 for services performed but not billed, and credits Service Revenue ₺200.

f. The company needs two additional accounts relating to interest. It debits Interest Expense ₺50 for accrued interest, and credits Interest Payable ₺50.

g. Yazici debits Salaries and Wages Expense ₺1,200 for accrued salaries, and credits an additional account, Salaries and Wages Payable, ₺1,200.

After Yazici has entered all the adjustments, the adjustments columns are totaled to prove their equality.

ILLUSTRATION 4.3 Entering the adjustments in the adjustments columns



Yazici Advertising A.Ş.
Worksheet
For the Month Ended October 31, 2025

Account Titles	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Income Statement Dr.	Income Statement Cr.	Statement of Financial Position Dr.	Statement of Financial Position Cr.
Cash	15,200									
Supplies	2,500			(a) 1,500						
Prepaid Insurance	600			(b) 50						
Equipment	5,000									
Notes Payable		5,000								
Accounts Payable		2,500								
Unearned Service Revenue		1,200	(d) 400							
Share Capital—Ordinary		10,000								
Dividends	500									
Service Revenue		10,000		(d) 400						
				(e) 200						
Salaries and Wages Expense	4,000		(g) 1,200							
Rent Expense	900									
Totals	28,700	28,700								
Supplies Expense			(a) 1,500							
Insurance Expense			(b) 50							
Accum. Depreciation—Equipment				(c) 40						
Depreciation Expense			(c) 40							
Accounts Receivable			(e) 200							
Interest Expense			(f) 50							
Interest Payable				(f) 50						
Salaries and Wages Payable				(g) 1,200						
Totals			3,440	3,440						

Add additional accounts as needed to complete the adjustments:
(a) Supplies Used.
(b) Insurance Expired.
(c) Depreciation Expensed.
(d) Service Revenue Recognized.
(e) Service Revenue Accrued.
(f) Interest Accrued.
(g) Salaries Accrued.

Enter adjustment amounts in appropriate columns, and use letters to cross-reference the debit and credit adjustments.

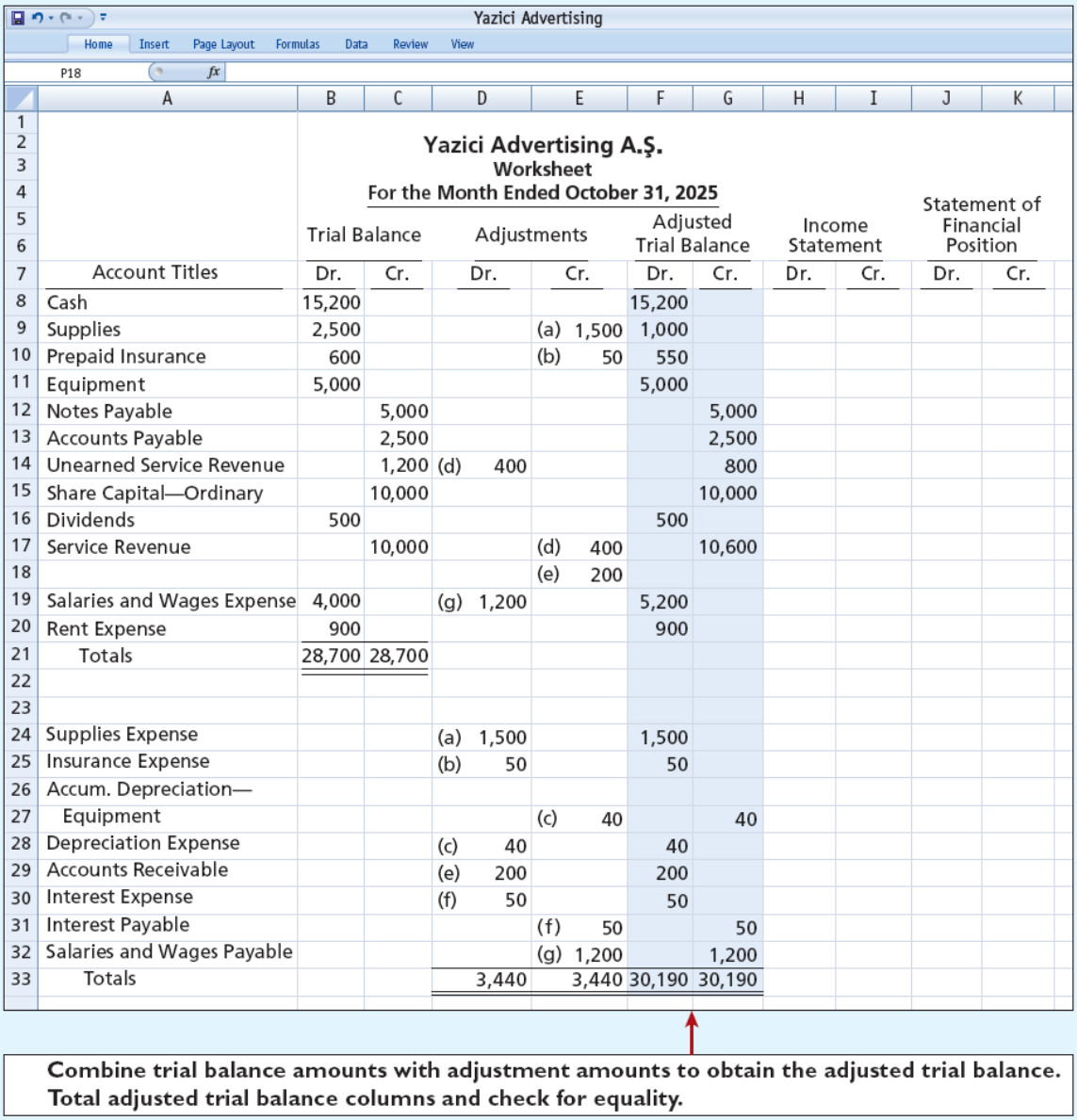
Total adjustments columns and check for equality.

Step 3 Enter Adjusted Balances in the Adjusted Trial Balance Columns

As shown in Illustration 4.4, Yazici Advertising next determines the adjusted balance of an account by combining the amounts entered in the first four columns of the worksheet for each account. For example, the Prepaid Insurance account in the trial balance columns has a ₺600 debit balance and a ₺50 credit in the adjustments columns. The result is a ₺550 debit balance recorded in the adjusted trial balance columns. **For each account, the amount in the adjusted trial balance columns is the balance that will appear in the ledger after journalizing and posting the adjusting entries.** The balances in these columns are the same as those in the adjusted trial balance in Illustration 3.26.

After Yazici has entered all account balances in the adjusted trial balance columns, the columns are totaled to prove their equality. If the column totals do not agree, the financial statement columns will not balance and the financial statements will be incorrect.

ILLUSTRATION 4.4 Entering adjusted balances in the adjusted trial balance columns



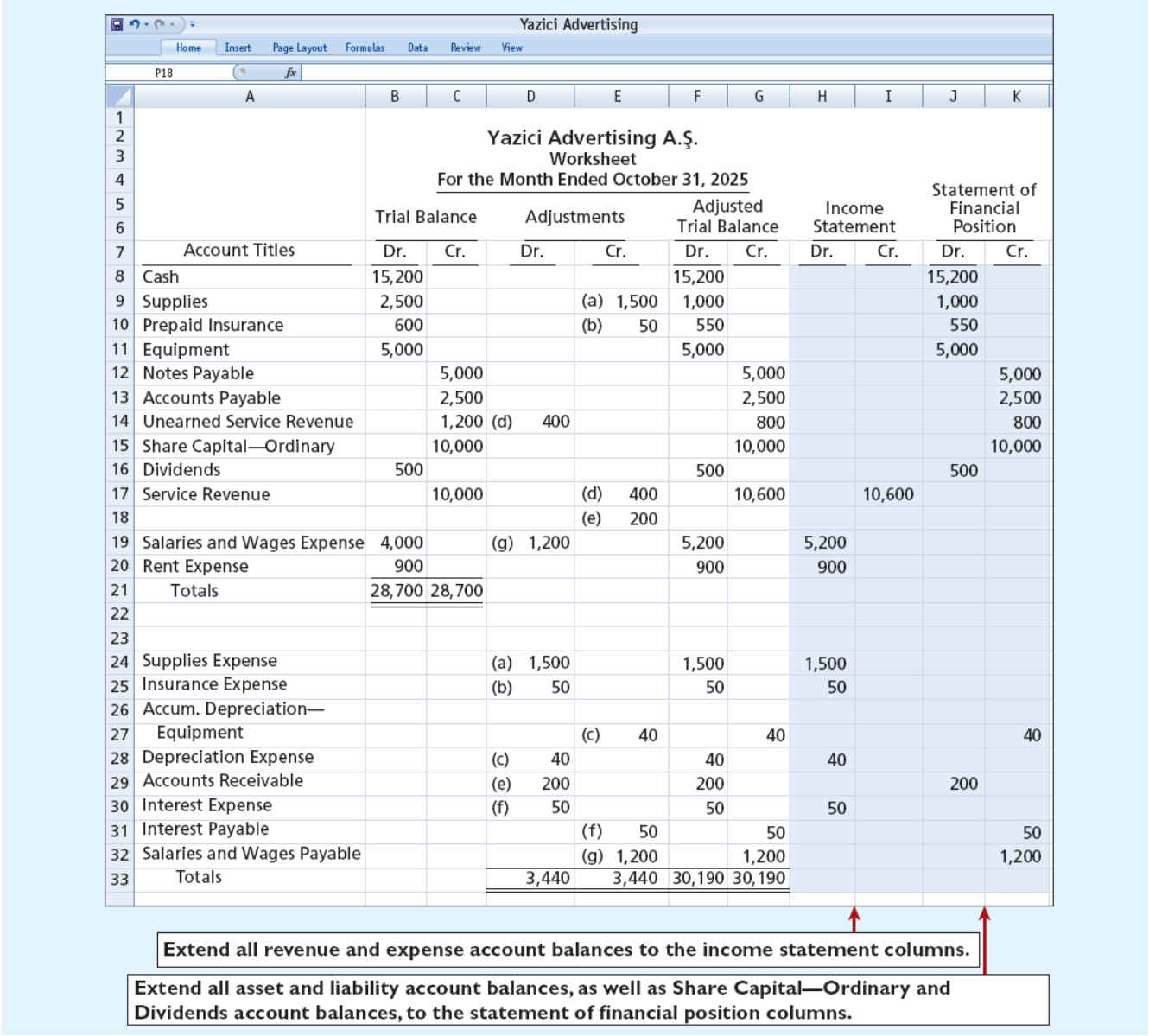
Step 4 Extend Adjusted Trial Balance Amounts to Appropriate Financial Statement Columns

As shown in Illustration 4.5, the fourth step is to extend adjusted trial balance amounts to the income statement and statement of financial position columns of the worksheet (see Helpful Hint). Yazici Advertising enters statement of financial position accounts in the appropriate statement of financial position debit and credit columns. For instance, it enters Cash in the statement of financial position debit column, and Notes Payable in the statement of financial position credit column. Yazici extends Accumulated Depreciation—Equipment to the statement of financial position credit column. The reason is that accumulated depreciation is a contra asset account with a credit balance.

> **HELPFUL HINT**
>
> Every adjusted trial balance amount must be extended to one of the four statement columns.

Because the worksheet does not have columns for the retained earnings statement, Yazici extends the balance in Share Capital—Ordinary and Retained Earnings, if any, to the statement of financial position credit column. In addition, it extends the balance in Dividends to the statement of financial position debit column because it is an equity account with a debit balance.

ILLUSTRATION 4.5 Extending the adjusted trial balance amounts to appropriate financial statement columns



Step 5 Total the Statement Columns, Compute the Net Income (or Net Loss), and Complete the Worksheet

As shown in **Illustration 4.6**, Yazici Advertising must now total each of the financial statement columns. The net income or loss for the period is the difference between the totals of the two income statement columns.

If total credits exceed total debits, the result is net income.

- In such a case, the company inserts the words "Net Income" in the account titles space.
- It then enters the amount in the income statement debit column and the statement of financial position credit column. **The debit amount balances the income statement columns; the credit amount balances the statement of financial position columns.**
- In addition, the credit in the statement of financial position column indicates the increase in equity resulting from net income.

What if total debits in the income statement columns exceed total credits?

- In that case, Yazici has a net loss.
- It enters the amount of the net loss in the income statement credit column and the statement of financial position debit column.

After entering the net income or net loss, Yazici determines new column totals.

The totals shown in the debit and credit income statement columns will match. So will the totals shown in the debit and credit statement of financial position columns. If either the income statement columns or the statement of financial position columns are not equal after the net income or net loss has been entered, there is an error in the worksheet.

ILLUSTRATION 4.6 Computing net income or net loss and completing the worksheet

Yazici Advertising

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Yazici Advertising A.Ş.
Worksheet
For the Month Ended October 31, 2025

Account Titles	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Income Statement Dr.	Income Statement Cr.	Statement of Financial Position Dr.	Statement of Financial Position Cr.
Cash	15,200				15,200				15,200	
Supplies	2,500			(a) 1,500	1,000				1,000	
Prepaid Insurance	600			(b) 50	550				550	
Equipment	5,000				5,000				5,000	
Notes Payable		5,000				5,000				5,000
Accounts Payable		2,500				2,500				2,500
Unearned Service Revenue		1,200	(d) 400			800				800
Share Capital—Ordinary		10,000				10,000				10,000
Dividends	500				500				500	
Service Revenue		10,000		(d) 400		10,600		10,600		
				(e) 200						
Salaries and Wages Expense	4,000		(g) 1,200		5,200		5,200			
Rent Expense	900				900		900			
Totals	28,700	28,700								
Supplies Expense			(a) 1,500		1,500		1,500			
Insurance Expense			(b) 50		50		50			
Accum. Depreciation—Equipment				(c) 40		40				40
Depreciation Expense			(c) 40		40		40			
Accounts Receivable			(e) 200		200				200	
Interest Expense			(f) 50		50		50			
Interest Payable				(f) 50		50				50
Salaries and Wages Payable				(g) 1,200		1,200				1,200
Totals			3,440	3,440	30,190	30,190	7,740	10,600	22,450	19,590
Net Income							2,860			2,860
Totals							10,600	10,600	22,450	22,450

The difference between the totals of the two income statement columns determines net income or net loss.

Net income is extended to the credit column of the statement of financial position columns. (Net loss would be extended to the debit column.)

Preparing Financial Statements from a Worksheet

After a company has completed a worksheet, it has at hand all the data required for preparation of financial statements.

- The income statement is prepared from the income statement columns.
- The retained earnings statement and statement of financial position are prepared from the statement of financial position columns.

Illustration 4.7 shows the financial statements prepared from Yazici Advertising's worksheet. At this point, the company has not journalized or posted adjusting entries. Therefore, ledger balances for some accounts are not the same as the financial statement amounts.

The amount shown for Share Capital—Ordinary on the worksheet does not change from the beginning to the end of the period unless the company issues additional ordinary shares during the period. Because there was no balance in Yazici's Retained Earnings, the account is not listed on the worksheet. Only after dividends and net income (or loss) are posted to Retained Earnings does this account have a balance at the end of the first year of the business.

Using a worksheet, companies can prepare financial statements before they journalize and post adjusting entries.

- However, the completed worksheet is not a substitute for formal financial statements. The format of the data in the financial statement columns of the worksheet is not the same as the format of the financial statements.
- A worksheet is essentially a working tool of the accountant; companies do not distribute it to management and other parties.

ILLUSTRATION 4.7 **Financial statements from a worksheet**

Yazici Advertising A.Ş.
Income Statement
For the Month Ended October 31, 2025

Revenues		
Service revenue		₺10,600
Expenses		
Salaries and wages expense	₺5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		₺ 2,860

Yazici Advertising A.Ş.
Retained Earnings Statement
For the Month Ended October 31, 2025

Retained earnings, October 1	₺ –0–
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	₺2,360

Yazici Advertising A.Ş.
Statement of Financial Position
October 31, 2025

Assets		
Equipment	₺5,000	
Less: Accumulated depreciation—equipment	40	₺ 4,960
Prepaid insurance		550
Supplies		1,000
Accounts receivable		200
Cash		15,200
Total assets		₺21,910
Equity and Liabilities		
Equity		
Share capital—ordinary	₺10,000	
Retained earnings	2,360	₺12,360
Liabilities		
Notes payable	5,000	
Accounts payable	2,500	
Interest payable	50	
Unearned service revenue	800	
Salaries and wages payable	1,200	9,550
Total equity and liabilities		₺21,910

Preparing Adjusting Entries from a Worksheet

A worksheet is not a journal, and it cannot be used as a basis for posting to ledger accounts. To adjust the accounts, the company must journalize the adjustments and post them to the ledger.

- The adjusting entries are prepared from the adjustments columns of the worksheet.
- The reference letters in the adjustments columns and the explanations of the adjustments at the bottom of the worksheet help identify the adjusting entries (see **Helpful Hint**).
- The journalizing and posting of adjusting entries follows the preparation of financial statements when a worksheet is used.

> **HELPFUL HINT**
> **Note that writing the explanation to the adjustment at the bottom of the worksheet is not required.**

The adjusting entries on October 31 for Yazici Advertising are the same as those shown in Illustration 3.24.

DO IT! 1

Worksheet

Susan Elbe is preparing a worksheet. Explain to Susan how she should extend the following adjusted trial balance accounts to the financial statement columns of the worksheet.

Cash	Dividends
Accumulated Depreciation—Equipment	Service Revenue
Accounts Payable	Salaries and Wages Expense

ACTION PLAN

- **Statement of financial position: Extend assets to debit column. Extend liabilities to credit column. Extend contra assets to credit column. Extend Dividends account to debit column.**
- **Income statement: Extend expenses to debit column. Extend revenues to credit column.**

Solution

Related exercise material: BE4.1, BE4.2, BE4.3, DO IT! 4.1, E4.1, E4.2, E4.3, E4.5, and E4.6.

4.2 Closing the Books

LEARNING OBJECTIVE 2

Prepare closing entries and a post-closing trial balance.



At the end of the accounting period, the company makes the accounts ready for the next period. This is called **closing the books**. In closing the books, the company distinguishes between temporary and permanent accounts.

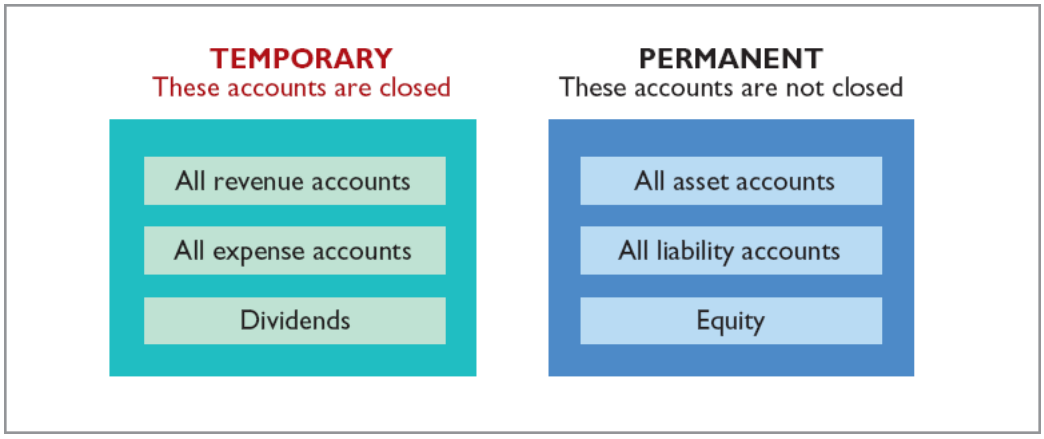
- Temporary accounts relate only to a given accounting period. They include all income statement accounts and the Dividends account. **The company closes all temporary accounts at the end of the period.**
- Permanent accounts relate to one or more future accounting periods. They consist of all statement of financial position accounts, including equity accounts. **Permanent accounts are not closed from period to period.** Instead, the company carries forward the balances of permanent accounts into the next accounting period.

Illustration 4.8 identifies the accounts in each category (see Alternative Terminology).

ALTERNATIVE TERMINOLOGY

Temporary accounts are sometimes called *nominal accounts*, and permanent accounts are sometimes called *real accounts*.

ILLUSTRATION 4.8 **Temporary versus permanent accounts**



Preparing Closing Entries

At the end of the accounting period, the company transfers temporary account balances to the permanent equity account, Retained Earnings, by means of closing entries.

- Closing entries formally recognize in the ledger the transfer of net income (or net loss) and Dividends to Retained Earnings. The retained earnings statement shows the results of these entries.
- **Closing entries also produce a zero balance in each temporary account.**
- The temporary accounts are then ready to accumulate data in the next accounting period separate from the data of prior periods. Permanent accounts are not closed.

Journalizing and posting closing entries is a required step in the accounting cycle (see Illustration 4.15). The company performs this step after it has prepared financial statements. In contrast to the steps in the cycle that you have already studied, companies generally journalize and post closing entries **only at the end of the annual accounting period**. Thus, all temporary accounts will contain data for the entire accounting period.

In preparing closing entries, companies could close each income statement account directly to Retained Earnings. However, to do so would result in excessive detail in the permanent Retained Earnings account.

- Instead, companies close the revenue and expense accounts to another temporary account, **Income Summary**.
- They then transfer the resulting net income or net loss from this account to Retained Earnings.

Companies **record closing entries in the general journal**. A center caption, Closing Entries, inserted in the journal between the last adjusting entry and the first closing entry, identifies these entries. Then the company posts the closing entries to the ledger accounts.

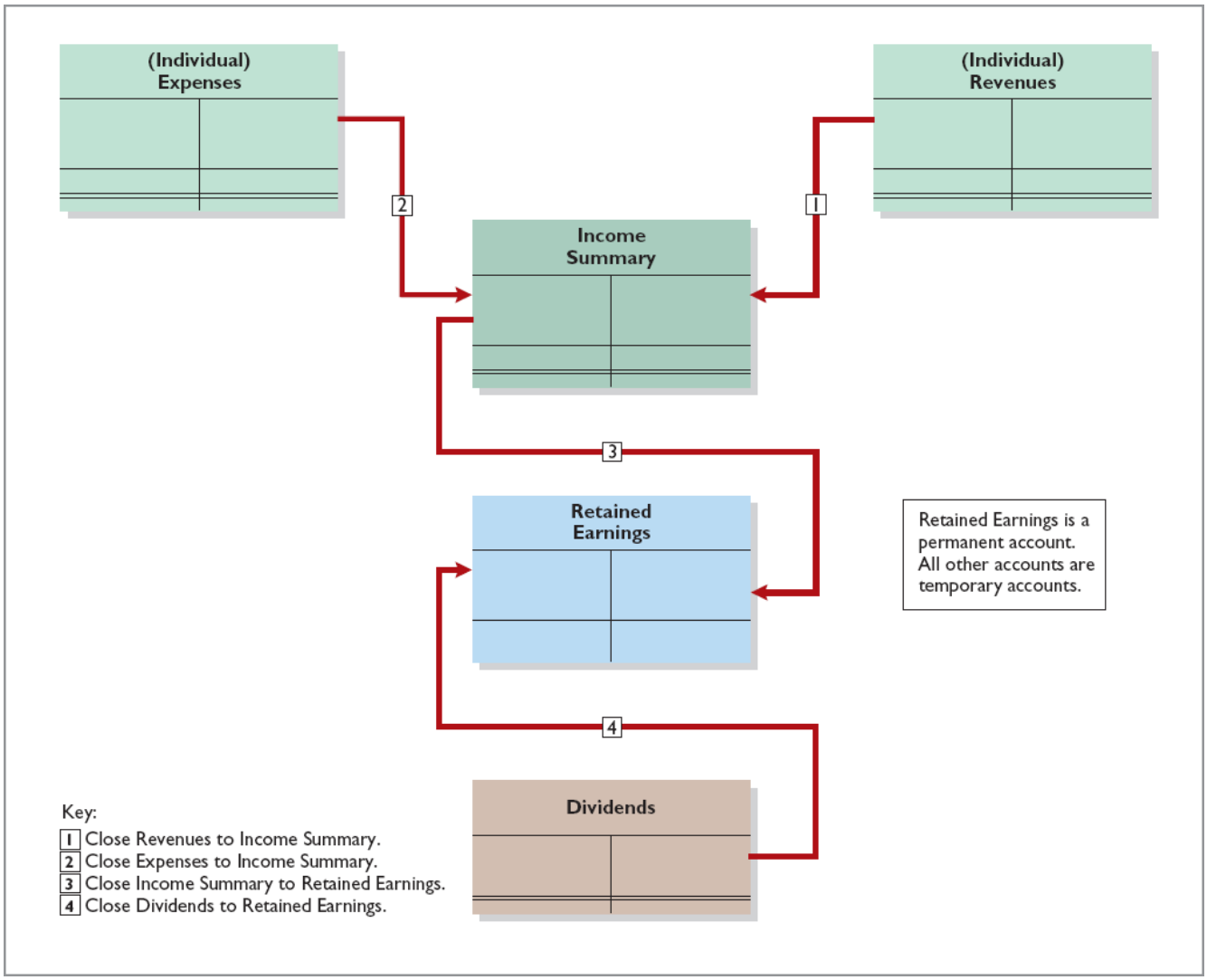
Companies generally prepare closing entries directly from the adjusted balances in the ledger. They could prepare separate closing entries for each nominal account, but the following four entries accomplish the desired result more efficiently:

1. Debit each revenue account for its balance, and credit Income Summary for total revenues.
2. Debit Income Summary for total expenses, and credit each expense account for its balance.
3. Debit Income Summary and credit Retained Earnings for the amount of net income.
4. Debit Retained Earnings for the balance in the Dividends account, and credit Dividends for the same amount (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Dividends are closed directly to Retained Earnings and not to Income Summary. Dividends are not an expense.**

Illustration 4.9 presents a diagram of the closing process. In it, the boxed numbers refer to the four entries required in the closing process.

ILLUSTRATION 4.9 Diagram of closing process



If there were a net loss (because expenses exceeded revenues), entry 3 in Illustration 4.9 would be reversed: there would be a credit to Income Summary and a debit to Retained Earnings.

Many companies have begun to employ **robotic process automation (RPA)** to improve their closing process. RPA involves the use of computer programs, instead of humans, to perform repetitive rules-based tasks. We will discuss other applications of RPA in later chapters.

Closing Entries Illustrated

In practice, companies generally prepare closing entries only at the end of the annual accounting period. However, to illustrate the journalizing and posting of closing entries, we will assume that Yazici Advertising closes its books monthly. **Illustration 4.10** shows the closing entries at October 31. (The numbers in parentheses before each entry correspond to the four entries diagrammed in Illustration 4.9.)

ILLUSTRATION 4.10 Closing entries journalized

GENERAL JOURNAL J3

Date	Account Titles and Explanation	Ref.	Debit	Credit
	Closing Entries			
2025	(1)			
Oct. 31	Service Revenue	400	10,600	
	Income Summary	350		10,600
	(To close revenue account)			
	(2)			
31	Income Summary	350	7,740	
	Supplies Expense	631		1,500
	Depreciation Expense	711		40
	Insurance Expense	722		50
	Salaries and Wages Expense	726		5,200
	Rent Expense	729		900
	Interest Expense	905		50
	(To close expense accounts)			
	(3)			
31	Income Summary (₺10,600 − ₺7,740)	350	2,860	
	Retained Earnings	320		2,860
	(To close net income to retained earnings)			
	(4)			
31	Retained Earnings	320	500	
	Dividends	332		500
	(To close dividends to retained earnings)			

Note that the amounts for Income Summary in entries (1) and (2) are the totals of the income statement credit and debit columns, respectively, in the worksheet.

A couple of cautions in preparing closing entries.

1. Avoid unintentionally doubling the revenue and expense balances rather than zeroing them.
2. Do not close Dividends through the Income Summary account. **Dividends are not an expense, and they are not a factor in determining net income.**

Posting Closing Entries

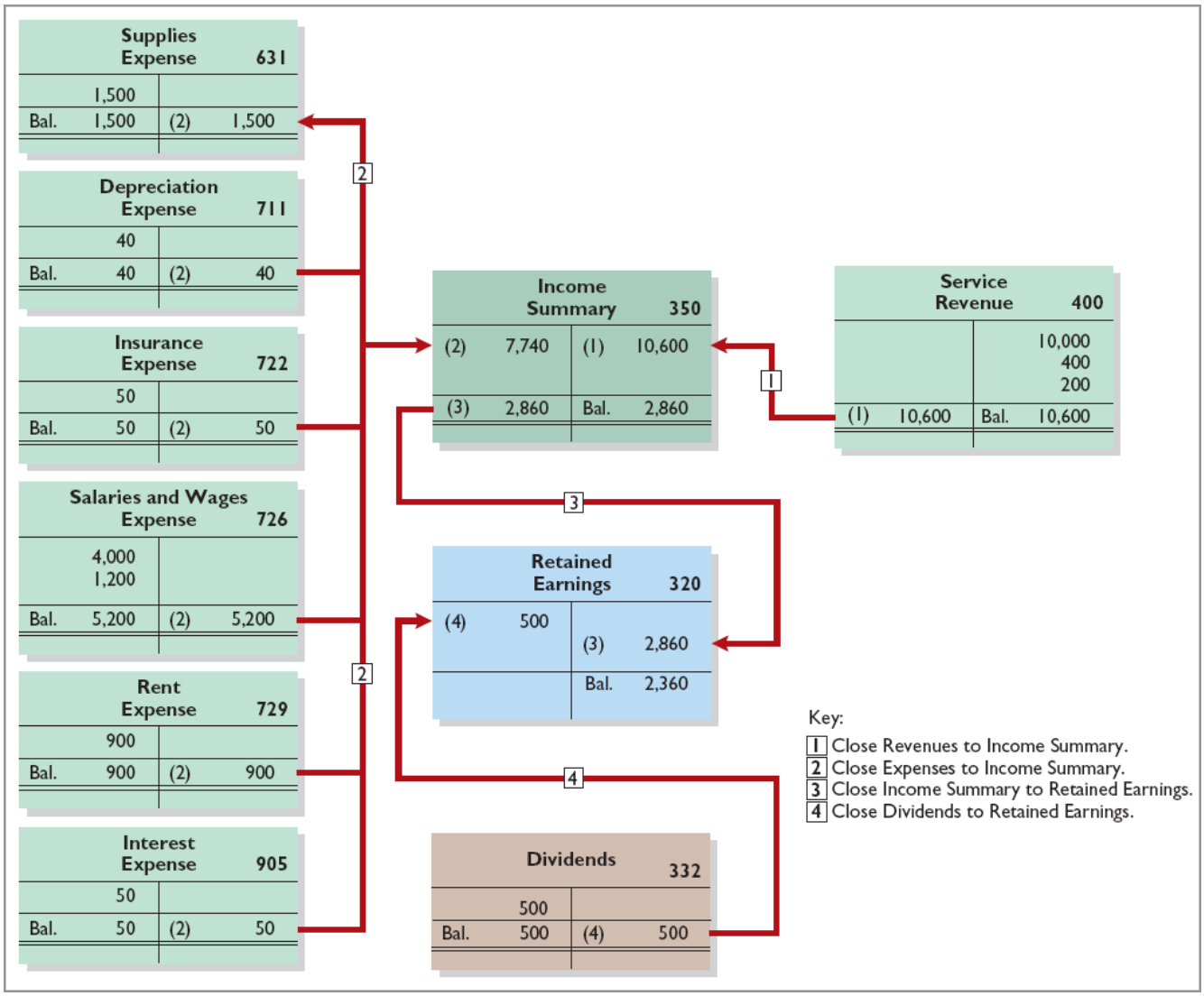
Illustration 4.11 shows the posting of the closing entries and the underlining (ruling) of the accounts.

- Note that all temporary accounts have zero balances after posting the closing entries.
- Realize that the balance in Retained Earnings represents the accumulated undistributed earnings of the corporation at the end of the accounting period. This balance is shown on the statement of financial position and is the ending amount reported on the retained earnings statement, as shown in Illustration 4.7.

Yazici Advertising uses the Income Summary account only in closing. It does not journalize and post entries to this account during the year (see Helpful Hint).

> **HELPFUL HINT**
>
> **The balance in Income Summary before it is closed must equal the net income or net loss for the period.**

ILLUSTRATION 4.11 Posting of closing entries



As part of the closing process, Yazici totals, balances, and double-underlines its temporary accounts—revenues, expenses, and Dividends, as shown in T-account form in Illustration 4.11. It does not close its permanent accounts—assets, liabilities, and equity (Share Capital—Ordinary and Retained Earnings). Instead, Yazici draws a single underline beneath the current-period entries for the permanent accounts. The account balance is then entered below the single underline and is carried forward to the next period (for example, see Retained Earnings).

Accounting Across the Organization

Transforming the Closing Process



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Getty images

Companies constantly look throughout their organization to find more efficient and effective ways to conduct business. The closing process is one of the areas where companies are always looking for improvement. The overall goal is to become more efficient by reducing the amount of time and effort that it takes to close the books each period, while ensuring that the closing process is as error-free as possible.

Like many aspects of business, new technologies are helping to improve the closing process. Companies now use software robots and processing mining to drive this forward. The robots work without the need for time off or even rest and do so with high accuracy. Process mining is used to identify and remove parts of the closing process that are slow or error-prone. The benefits to the business are not only a better closing process but freeing up time for the accounting staff to focus on higher-value activities, such as analysis and planning.

Source: Adapted from Nicolas Valette, Ludovic Deprez, and Camille Marchand, "Staying on Top of Your Financial Closing Process," *ey.com* (June 24, 2021).

Who else benefits from a shorter closing process?

Answer

Preparing a Post-Closing Trial Balance

After Yazici Advertising has journalized and posted all closing entries, it prepares another trial balance, called a **post-closing trial balance**, from the ledger.

- The post-closing trial balance lists permanent accounts and their balances after the journalizing and posting of closing entries.
- The purpose of the post-closing trial balance is **to prove the equality of the permanent account balances carried forward into the next accounting period**.
- Since all temporary accounts will have zero balances, **the post-closing trial balance will contain only permanent—statement of financial position—accounts**.

Illustration 4.12 shows the post-closing trial balance for Yazici Advertising A.Ş.

ILLUSTRATION 4.12 Post-closing trial balance

Yazici Advertising A.Ş.
Post-Closing Trial Balance
October 31, 2025

	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Share Capital—Ordinary		10,000
Retained Earnings		2,360
	₺21,950	**₺21,950**

Yazici prepares the post-closing trial balance from the permanent accounts in the ledger. Illustration 4.13 shows the permanent accounts in Yazici's general ledger.

ILLUSTRATION 4.13 General ledger, permanent accounts

(Permanent Accounts Only)

GENERAL LEDGER

Cash **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		**15,200**

Accounts Receivable **No. 112**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2	**200**		**200**

Supplies **No. 126**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1	2,500		2,500
31	Adj. entry	J2		**1,500**	**1,000**

Prepaid Insurance **No. 130**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 4		J1	600		600
31	Adj. entry	J2		**50**	**550**

Equipment **No. 157**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	5,000		**5,000**

Accumulated Depreciation—Equipment **No. 158**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2		**40**	**40**

Notes Payable **No. 200**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		5,000	**5,000**

Accounts Payable **No. 201**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1	2,500		**2,500**

Unearned Service Revenue **No. 209**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 2		J1		1,200	1,200
31	Adj. entry	J2	400		**800**

Salaries and Wages Payable **No. 212**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2		**1,200**	**1,200**

Interest Payable **No. 230**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2		**50**	**50**

Share Capital—Ordinary **No. 311**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		10,000	10,000

Retained Earnings **No. 320**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1					–0–
31	**Closing entry**	**J3**		**2,860**	**2,860**
31	**Closing entry**	**J3**	**500**		**2,360**

Note: The permanent accounts for Yazici Advertising are shown here. Illustration 4.14 shows the temporary accounts. Both permanent and temporary accounts are part of the general ledger. They are segregated here to aid in learning.

A post-closing trial balance provides evidence that the company has properly journalized and posted the closing entries. It also shows that the accounting equation is in balance at the end of the accounting period. However, like the trial balance, it does not prove that Yazici has recorded all transactions or that the ledger is correct. For example, the post-closing trial balance still will balance even if a transaction is not journalized and posted or if a transaction is journalized and posted twice.

The remaining accounts in the general ledger are temporary accounts, shown in **Illustration 4.14**. After Yazici correctly posts the closing entries, each temporary account has a zero balance. These accounts are double-underlined to finalize the closing process.

ILLUSTRATION 4.14 General ledger, temporary accounts

(Temporary Accounts Only)

GENERAL LEDGER

Dividends **No. 332**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 20		J1	500		500
31	**Closing entry**	**J3**		**500**	**–0–**

Income Summary **No. 350**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	**Closing entry**	**J3**		**10,600**	**10,600**
31	**Closing entry**	**J3**	**7,740**		**2,860**
31	**Closing entry**	**J3**	**2,860**		**–0–**

Service Revenue **No. 400**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31		J1		10,000	10,000
31	Adj. entry	J2		400	10,400
31	Adj. entry	J2		200	10,600
31	**Closing entry**	**J3**	**10,600**		**–0–**

Supplies Expense **No. 631**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2	1,500		1,500
31	**Closing entry**	**J3**		**1,500**	**–0–**

Depreciation Expense **No. 711**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2	**40**		40
31	**Closing entry**	**J3**		**40**	**–0–**

Insurance Expense **No. 722**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2	**50**		50
31	**Closing entry**	**J3**		**50**	**–0–**

Salaries and Wages Expense **No. 726**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 26		J1	4,000		4,000
31	Adj. entry	J2	**1,200**		5,200
31	**Closing entry**	**J3**		**5,200**	**–0–**

Rent Expense **No. 729**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 3		J1	900		900
31	**Closing entry**	**J3**		**900**	**–0–**

Interest Expense **No. 905**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 31	Adj. entry	J2	**50**		50
31	**Closing entry**	**J3**		**50**	**–0–**

Note: The temporary accounts for Yazici Advertising are shown here. Illustration 4.13 shows the permanent accounts. Both permanent and temporary accounts are part of the general ledger. They are segregated here to aid in learning.

DO IT! 2

Closing Entries

Hancock Heating has the following balances in selected accounts of its adjusted trial balance.

Accounts Payable	€27,000	Dividends	€15,000
Service Revenue	98,000	Share Capital—Ordinary	42,000
Rent Expense	22,000	Accounts Receivable	38,000
Salaries and Wages Expense	51,000	Supplies Expense	7,000

Prepare the closing entries at December 31.

ACTION PLAN

- **Close revenue and expense accounts to Income Summary.**
- **Close Income Summary to Retained Earnings.**
- **Close Dividends to Retained Earnings.**

Solution

Related exercise material: **BE4.4**, **BE4.5**, **BE4.6**, **BE4.7**, **DO IT! 4.2**, **E4.4**, **E4.7**, **E4.8**, **and E4.11**.

4.3 The Accounting Cycle and Correcting Entries

LEARNING OBJECTIVE 3

Explain the steps in the accounting cycle and how to prepare correcting entries.

Summary of the Accounting Cycle

Illustration 4.15 summarizes the steps in the accounting cycle. You can see that the cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. Companies perform the steps in the cycle in sequence and repeat them in each accounting period.

- Steps 1–3 may occur daily during the accounting period.
- Companies perform Steps 4–7 on a periodic basis, such as monthly, quarterly, or annually.
- Steps 8 and 9—closing entries and a post-closing trial balance—usually take place only at the end of a company's **annual** accounting period.

There are also two **optional steps** in the accounting cycle. As you have seen, companies may use a worksheet in preparing adjusting entries and financial statements. In addition, they may use reversing entries, as explained below.

Reversing Entries—An Optional Step

Some accountants prefer to reverse certain adjusting entries by making a reversing entry at the beginning of the next accounting period. A reversing entry is the exact opposite of the adjusting entry made in the previous period. **Use of reversing entries is an optional bookkeeping procedure; it is not a required step in the accounting cycle.** Accordingly, we have chosen to cover this topic in an appendix at the end of the chapter.

Correcting Entries—An Avoidable Step

Unfortunately, errors may occur in the recording process. Companies should correct errors, **as soon as they discover them**, by journalizing and posting correcting entries. If the accounting records are free of errors, no correcting entries are needed.

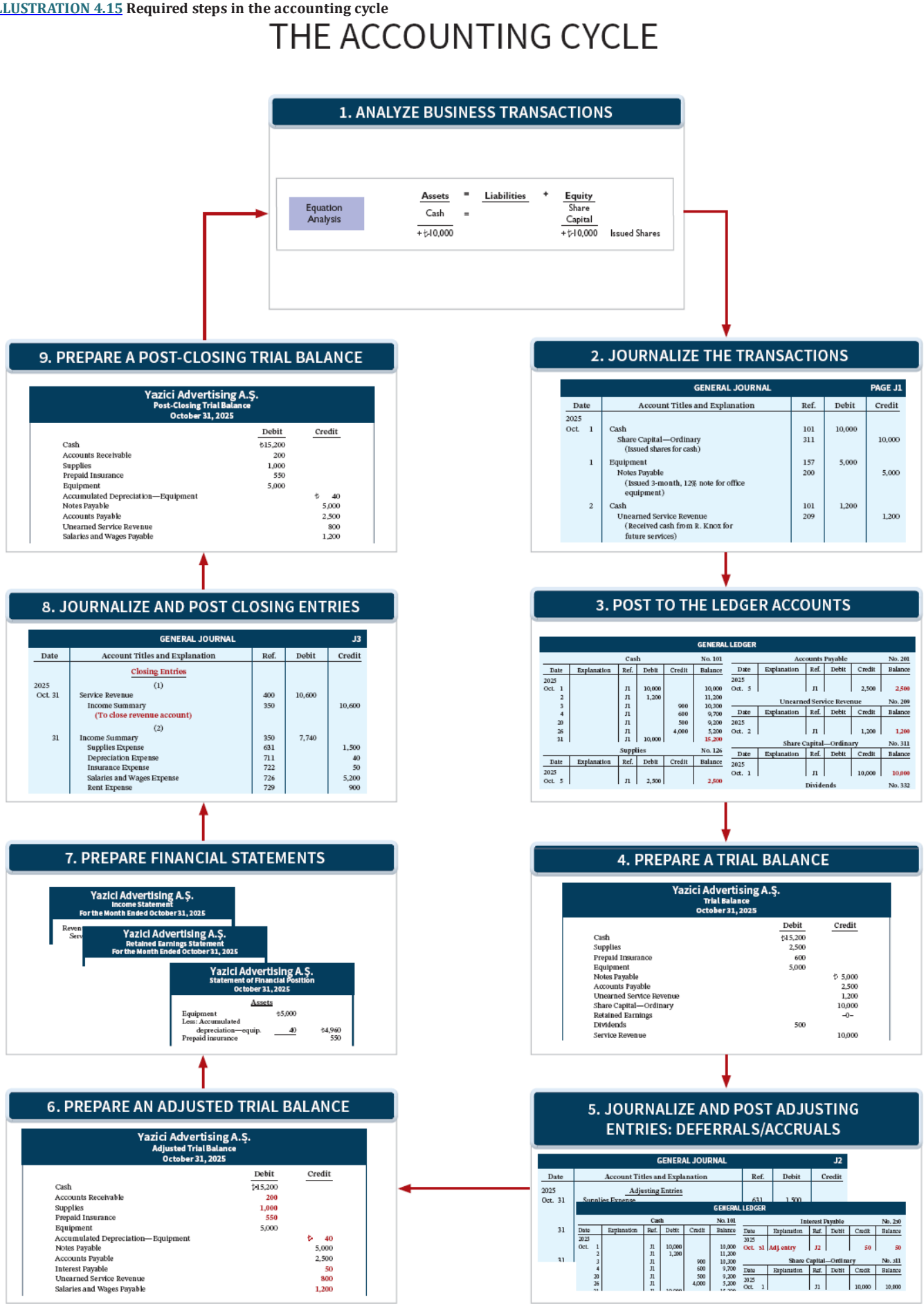
You should recognize several differences between correcting entries and adjusting entries.

- Adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records are error-free.
- Companies journalize and post adjustments **only at the end of an accounting period**. In contrast, companies make correcting entries **whenever they discover an error** (see Ethics Note).

ETHICS NOTE

When companies find errors in previously released income statements, they restate those numbers.

ILLUSTRATION 4.15 Required steps in the accounting cycle



- Adjusting entries always affect at least one statement of financial position account and one income statement account. In contrast, correcting entries may involve any combination of accounts in need of correction. **Correcting entries must be posted before closing entries.**

To determine the correcting entry, it is useful to compare the incorrect entry with the correct entry. Doing so helps identify the accounts and amounts that should—and should not—be corrected. After comparison, the accountant makes an entry to correct the accounts. The following two cases for Mercato Co. illustrate this approach.

Case 1

On May 10, Mercato Co. journalized and posted a NT$500 cash collection on account from a customer as a debit to Cash NT$500 and a credit to Service Revenue NT$500. The company discovered the error on May 20, when the customer paid the remaining balance in full (see Illustration 4.16).

ILLUSTRATION 4.16 Comparison of entries

Incorrect Entry (May 10)			Correct Entry (May 10)		
Cash	500		Cash	500	
Service Revenue		500	Accounts Receivable		500

Comparison of the incorrect entry with the correct entry reveals that the debit to Cash NT$500 is correct. However, the NT$500 credit to Service Revenue should have been credited to Accounts Receivable. As a result, both Service Revenue and Accounts Receivable are overstated in the ledger. Mercato makes the correcting entry shown in Illustration 4.17.

ILLUSTRATION 4.17 Correcting entry

Correcting Entry

May 20	Service Revenue	500	
	Accounts Receivable		500
	(To correct entry of May 10)		

A	=	L	+	E
				−500 Rev
−500				

Cash Flows
no effect

Case 2

On May 18, Mercato purchased on account equipment costing NT$4,500. The transaction was journalized and posted as a debit to Equipment NT$450 and a credit to Accounts Payable NT$450. The error was discovered on June 3, when Mercato received the monthly statement for May from the creditor (see Illustration 4.18).

ILLUSTRATION 4.18 Comparison of entries

Incorrect Entry (May 18)			Correct Entry (May 18)		
Equipment	450		Equipment	4,500	
Accounts Payable		450	Accounts Payable		4,500

Comparison of the two entries shows that two accounts are incorrect. Equipment is understated NT$4,050, and Accounts Payable is understated NT$4,050. Mercato makes the correcting entry shown in Illustration 4.19.

ILLUSTRATION 4.19 Correcting entry

Correcting Entry

June 3	Equipment	4,050	
	Accounts Payable		4,050
	(To correct entry of May 18)		

A	=	L	+	E
+4,050				
		+4,050		

Cash Flows
no effect

Instead of preparing a correcting entry, **it is possible to reverse the incorrect entry and then prepare the correct entry**. This approach will result in more entries and postings than a correcting entry, but it will accomplish the desired result.

Investor Insight

Nigerian Stock Exchange

How Can Accounting Aid African Growth?



Daniel Ernst/Adobe Stock Photos

The accuracy of a company's financial records is very important to investors, but other issues are also of concern. Recently, the **Nigerian Stock Exchange** adopted a company-governance system to assess the 190 companies that are listed on the exchange. The rating system requires the companies to answer questions about business ethics, audit procedures, internal controls, disclosure practices, and other matters. Africa's economy is growing rapidly, so it offers many opportunities to investors and companies.

But the accounting practices of many African companies lag behind those of companies in other parts of the world. In order to attract more outside investment and therefore lower the cost of financing projects, many African companies have adopted IFRS. One financial advisor said that while trying to help one African company, she found accounts that were commingled and assets that had not been recorded because they had been purchased with cash. She emphasized, however, that "just because they don't have the best accounting records doesn't mean they don't have a good business."

Source: Adapted from Kimberly S. Johnson, "Africa Makes Strides in Corporate Accounting, Governance," *Wall Street Journal Online* (November 17, 2014).

What benefit is likely to result if African companies improve their accounting practices and adopt IFRS?

Answer

DO IT! 3

Correcting Entries

Sanchez Company discovered the following errors made in January 2025 (amounts in thousands).

1. A payment of Salaries and Wages Expense of $600 was debited to Supplies and credited to Cash, both for $600.
2. A collection of $3,000 from a client on account was debited to Cash $200 and credited to Service Revenue $200.
3. The purchase of supplies on account for $860 was debited to Supplies $680 and credited to Accounts Payable $680.

Correct the errors without reversing the incorrect entry.

ACTION PLAN

- **Compare the incorrect entry with correct entry.**
- **After comparison, make an entry to correct the accounts.**

Solution

Related exercise material: **BE4.8**, **BE4.9**, **DO IT! 4.3**, **E4.10**, **E4.12**, **and E4.13**.

4.4 Classified Statement of Financial Position

LEARNING OBJECTIVE 4

Identify the sections of a classified statement of financial position.

The statement of financial position presents a snapshot of a company's financial position at a point in time. To improve users' understanding of a company's financial position, companies often use a classified statement of financial position.

- A classified statement of financial position groups together similar assets and similar liabilities, using a number of standard classifications and sections.
- This is useful because items within a group have similar economic characteristics.

A classified statement of financial position generally contains the standard classifications listed in Illustration 4.20.

ILLUSTRATION 4.20 **Standard statement of financial position classifications**

Assets	Equity and Liabilities
Intangible assets	Equity
Property, plant, and equipment	Non-current liabilities
Long-term investments	Current liabilities
Current assets	

These groupings help financial statement readers determine:

1. Whether the company has enough assets to pay its debts as they come due.
2. The claims of short- and long-term creditors on the company's total assets.

Many of these groupings can be seen in the statement of financial position of Cheng Ltd. shown in Illustration 4.21 (see Helpful Hint). In the sections that follow, we explain each of these groupings.

> **HELPFUL HINT**
> **Recall that the basic accounting equation is Assets = Liabilities + Equity.**

ILLUSTRATION 4.21 **Classified statement of financial position**

Cheng Ltd.
Statement of Financial Position
October 31, 2025
(NT$ in thousands)

Assets			
Intangible assets			
Patents			NT$ 3,100
Property, plant, and equipment			
Land		NT$10,000	
Equipment	NT$24,000		
Less: Accumulated depreciation—equipment	5,000	19,000	29,000
Long-term investments			
Investment in shares of Walters Corp.		5,200	
Investment in real estate		2,000	7,200
Current assets			
Prepaid insurance		400	
Supplies		2,100	
Inventory		3,000	
Notes receivable		1,000	
Accounts receivable		7,000	
Short-term investments		2,000	
Cash		6,600	22,100
Total assets			NT$61,400
Equity and Liabilities			
Equity			
Share capital—ordinary		NT$20,000	
Retained earnings		14,050	NT$34,050
Non-current liabilities			
Mortgage payable		10,000	
Notes payable		1,300	11,300
Current liabilities			
Notes payable		11,000	
Accounts payable		2,100	
Salaries and wages payable		1,600	
Unearned service revenue		900	
Interest payable		450	16,050
Total equity and liabilities			NT$61,400

Intangible Assets

Many companies have long-lived assets that do not have physical substance yet often are very valuable. We call these assets **intangible assets**.

- One significant intangible asset is goodwill.
- Others include patents, copyrights, and trademarks or trade names that give the company **exclusive right** of use for a specified period of time.

In Illustration 4.21, Cheng Ltd. reported intangible assets of NT$3,100. Illustration 4.22 shows the intangible assets of **Nokia** (FIN) in a recent year (see Helpful Hint).

HELPFUL HINT

Sometimes intangible assets are reported under a broader heading called "*Other assets*."

ILLUSTRATION 4.22 Intangible assets section

Real World

Nokia
Statement of Financial Position (partial)
(in millions)

Intangible assets	
Capitalized development costs	€ 244
Goodwill	6,257
Other intangible assets	3,913
	€10,414

Environmental, Social, and Governance Insight

Nestlé SA

Creating Value



Simon Rawles/Alamy Stock Photo

Appendix B contains the financial statements of **Nestlé SA** (CHE). Those financial statements report on the company's profitability and financial position. In addition to these financial statements, Nestlé, like many other companies today, also reports its achievements with regard to other, non-financial goals.

In Nestlé's case, it calls these goals "Creating Shared Value." Nestlé has set objectives to help society in areas most directly related to its particular expertise: nutrition, water and environmental sustainability, and rural development. The company evaluates its progress in each area using objective measures. Examples of measures used are provided below.

Nutrition: Products meeting or exceeding Nutritional Foundation profiling criteria (as percentage of total sales) and products with increase in nutritious ingredients or essential nutrients.

Water and Environmental Sustainability: Reduce direct water withdrawals per tonne of product in every product category and also reduce greenhouse gas emissions per tonne of product in every product category.

Rural Development: Farmers trained through capacity-building programs and suppliers audited for food safety, quality, and processing.

To learn more about Nestlé's efforts to create shared value, go to the company's website.

What are some implications of Nestlé's decision to measure its non-financial results using objective measures and then publicly report these results?

Answer

Property, Plant, and Equipment

Property, plant, and equipment are assets with relatively long useful lives that a company is currently using in operating the business. This category includes land, buildings, machinery and equipment, delivery equipment, and furniture (see Alternative Terminology). In Illustration 4.21, Cheng Ltd. reported property, plant, and equipment of NT$29,000.

ALTERNATIVE TERMINOLOGY

Property, plant, and equipment is sometimes called *fixed assets* or *plant assets*.

Depreciation is the practice of allocating the cost of assets to a number of years.

- Companies systematically assign a portion of an asset's cost as an expense each year (rather than expensing the full purchase price in the year of purchase).
- The assets that the company depreciates are reported on the statement of financial position at cost less accumulated depreciation.
- The **accumulated depreciation** account shows the total amount of depreciation that the company has expensed thus far in the asset's life.

In Illustration 4.21, Cheng Ltd. reported accumulated depreciation of NT$5,000. **Illustration 4.23** presents the property, plant, and equipment of **Laclede Group** (KOR).

ILLUSTRATION 4.23 **Property, plant, and equipment section**

Real World

Laclede Group
Statement of Financial Position (partial)
(₩ in billions)

Property, plant, and equipment		
Land		₩ 2,604
Buildings	₩ 9,487	
Structures	1,568	
Machinery	36,956	
Vehicles	226	
Other	10,600	58,837
Less: Accumulated depreciation		32,617
		₩28,824

Long-Term Investments

Long-term investments are generally:

1. Investments in shares and bonds of other companies that are normally held for many years.
2. Non-current assets such as land or buildings that a company is not currently using in its operating activities.
3. Long-term notes receivable (see Alternative Terminology). In Illustration 4.21, Cheng Ltd. reported total long-term investments of NT$7,200 on its statement of financial position. **Alphabet Inc.** (USA) reported long-term investments in its statement of financial position, as shown in **Illustration 4.24**.

> **ALTERNATIVE TERMINOLOGY**
>
> **Long-term investments are often referred to simply as *investments*.**

ILLUSTRATION 4.24 **Long-term investments section**

Real World

Alphabet Inc.
Statement of Financial Position (partial)
(in thousands)

Long-term investments	
Non-marketable equity investments	$1,469

Current Assets

Current assets include cash, investments held for trading purposes, and assets that a company expects to convert to cash or use up within one year or its operating cycle, whichever is longer. In Illustration 4.21, Cheng Ltd. had current assets of NT$22,100. For most businesses, the cutoff for classification as current assets is one year from the statement of financial position date. For example, accounts receivable are current assets because the company will collect them and convert them to cash within one year. Supplies is a current asset because the company expects to use the supplies in operations within one year.

Some companies use a period longer than one year to classify assets and liabilities as current because they have an operating cycle longer than one year.

- The **operating cycle** of a company is the average time that it takes to purchase inventory, sell it on account, and then collect cash from customers.
- For most businesses, this cycle takes less than a year so they use a one-year cutoff.
- For other businesses, such as vineyards or airplane manufacturers, this period may be longer than a year.

Except where noted, we will assume that companies use one year to determine whether an asset or liability is current or non-current.

Common types of current assets are (1) cash, (2) investments (such as short-term government securities), (3) receivables (notes receivable, accounts receivable, and interest receivable), (4) inventories, and (5) prepaid expenses (supplies and insurance). **On the statement of financial position, companies usually list these items in the reverse order in which they expect to convert them into cash.** Illustration 4.25 presents the current assets of **Tesco** (GBR).

ILLUSTRATION 4.25 **Current assets section**

Real World

Tesco
Statement of Financial Position (partial)
(£ in millions)

Current assets	
Inventories	£2,430
Trade and other receivables	1,311
Derivative financial instruments	97
Current tax assets	6
Short-term investments	360
Cash and cash equivalents	1,788
Total current assets	£5,992

As we explain later in the chapter, a company's current assets are important in assessing its short-term debt-paying ability.

Equity

The content of the equity section varies with the form of business organization.

- In a proprietorship, there is one capital account.
- In a partnership, there is a capital account for each partner.
- Corporations often divide equity into two accounts—Share Capital—Ordinary and Retained Earnings.

Corporations record shareholders' investments in the company by debiting an asset account and crediting the Share Capital—Ordinary account. They record in the Retained Earnings account income retained for use in the business. Corporations combine the Share Capital—Ordinary and Retained Earnings accounts and report them on the statement of financial position as **equity**. **Halie Capital Ltd.** reported its equity section as shown in **Illustration 4.26**.

ILLUSTRATION 4.26 Equity section

Halie Capital Ltd.
Statement of Financial Position (partial)
(in thousands)

Equity	
Share capital—ordinary	£ 685,934
Retained earnings	1,406,747
Total equity	£2,092,681

Non-Current Liabilities

Non-current liabilities are obligations that a company expects to pay **after** one year.

- Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and pension liabilities.
- Many companies report long-term debt maturing after one year as a single amount in the statement of financial position and show the details of the debt in notes that accompany the financial statements. Others list the various types of non-current liabilities.

In Illustration 4.21, Cheng Ltd. reported non-current liabilities of NT$11,300. **Illustration 4.27** shows the non-current liabilities that **Siemens** (DEU) reported in its statement of financial position in a recent year.

ILLUSTRATION 4.27 Non-current liabilities section

Real World

Siemens
Statement of Financial Position (partial)
(in millions)

Non-current liabilities	
Long-term debt	€14,260
Pension plans and similar commitments	4,361
Provisions	2,533
Deferred tax liabilities	726
Other non-current liabilities	2,752
	€24,632

Current Liabilities

In the equity and liabilities section of the statement of financial position, the last grouping is current liabilities.

Current liabilities include liabilities related to the operations of the business as well as liabilities related to the financing of the business.

- Operating-related liabilities, for example, accounts payable and accrued expenses such as salaries and wages, are reported as current liabilities if they are due within one year or the operating cycle, whichever is longer (see Ethics Note).
- Financing-related liabilities such as interest payable and notes payable are treated as current if they are due within one year.
- In addition, any long-term debt that requires repayment within the next year is also a current liability.

> **ETHICS NOTE**
>
> **A company that has more current assets than current liabilities can increase the ratio of current assets to current liabilities by using cash to pay off some current liabilities. This gives the appearance of being more liquid. Do you think this move is ethical?**

As noted earlier, except where noted, we will assume that companies use one year to determine whether assets or liabilities are current or non-current.

In Illustration 4.21, Cheng Ltd. reported five different types of current liabilities, for a total of NT$16,050. **Illustration 4.28** shows the current liabilities section adapted from the statement of financial position of **Siemens** (DEU).

ILLUSTRATION 4.28 Current liabilities section

Real World

Siemens
Statement of Financial Position (partial)
(in millions)

Current liabilities	
Trade payables	€ 8,860
Current provisions	5,165
Other current financial liabilities	2,427
Income taxes payable	1,970
Current maturities for long-term debt	1,819
Other current liabilities	22,210
	€42,451



Users of financial statements look closely at the relationship between current assets and current liabilities. This relationship is important in evaluating a company's liquidity—its ability to pay obligations expected to be due within the next year. When current assets exceed current liabilities, the likelihood for paying the liabilities is favorable. When the reverse is true, short-term creditors may not be paid, and the company may ultimately be forced into bankruptcy.

Accounting Across the Organization

Managing Liquidity During a Global Pandemic



jorgeantonio/Getty Images

Companies face a constant challenge to manage their working capital and liquidity. Too much liquidity can be costly since liquid assets such as cash have a low rate of return. Too little liquidity can prevent the company for taking advantage of sales discounts, or even worse, cause them to miss payments that are due on their liabilities.

Given this backdrop, imagine how challenging liquidity management became during the Covid-19 global pandemic. For many companies, revenues dropped significantly, and accounts receivable were difficult to collect. Inventory swung widely–dropping quickly in industries such as medical protective equipment like masks and gloves, and building up quickly in industries like electronics and automotive production where production lines were essentially shut down early in the pandemic.

The Hackett Group (USA) assists large companies as they attempt to find the right balance. It reported that many large companies held onto their cash carefully during the pandemic, causing on average the amount of cash to go up by 40% compared to the pre-pandemic period. These companies did this by reducing capital expenditures and dividend payments along with tapping their short-term credit facilities.

Source: The Hackett Group.

What can various company managers do to ensure that working capital is managed efficiently to maximize net income?

Answer

DO IT! 4

Statement of Financial Position Classifications

The following accounts were taken from the financial statements of Callahan Company.

_____ Salaries and wages payable
_____ Service revenue
_____ Interest payable
_____ Goodwill
_____ Debt investments (short-term)
_____ Mortgage payable (due in 3 years)
_____ Share investments (long-term)
_____ Equipment
_____ Accumulated depreciation—equipment
_____ Depreciation expense
_____ Share capital—ordinary
_____ Unearned service revenue

Match each of the following to its proper statement of financial position classification, shown below. If the item would not appear on a statement of financial position, use "NA."

Intangible assets (IA)
Property, plant, and equipment (PPE)
Long-term investments (LTI)
Current assets (CA)
Equity (E)
Non-current liabilities (NCL)
Current liabilities (CL)

ACTION PLAN

- **Analyze whether each financial statement item is an asset, liability, or equity.**
- **Determine if asset and liability items are current or non-current.**

Solution

Related exercise material: **BE4.10**, **BE4.11**, **DO IT! 4.4**, **E4.3**, **E4.9**, **E4.14**, **E4.15**, **E4.16**, **and E4.17**.

Appendix 4A Reversing Entries

LEARNING OBJECTIVE *5

Prepare reversing entries.

After preparing the financial statements and closing the books, it is often helpful to reverse some of the adjusting entries before recording the regular transactions of the next period. Such entries are **reversing entries**.

- Companies make **a reversing entry at the beginning of the next accounting period**.
- Each reversing entry **is the exact opposite of the adjusting entry made in the previous period**.
- The recording of reversing entries is an **optional step** in the accounting cycle.

The purpose of reversing entries is to simplify the recording of a subsequent transaction related to an adjusting entry. For example, in Chapter 3, the payment of salaries after an adjusting entry resulted in two debits: one to Salaries and Wages Payable and the other to Salaries and Wages Expense. With reversing entries, the company can debit the entire subsequent payment to Salaries and Wages Expense. **The use of reversing entries does not change the amounts reported in the financial statements.** What it does is simplify the recording of subsequent transactions.

Reversing Entries Example

Companies most often use reversing entries to reverse two types of adjusting entries: accrued revenues and accrued expenses. To illustrate the optional use of reversing entries for accrued expenses, we will use the salaries expense transactions for Yazici Advertising as illustrated in Chapters 2, 3, and 4. The transaction and adjustment data are as follows.

1. October 26 (initial salary entry): Yazici pays ₺4,000 of salaries and wages earned between October 15 and October 26.
2. October 31 (adjusting entry): Salaries and wages earned between October 29 and October 31 are ₺1,200. The company will pay these in the November 9 payroll.
3. November 9 (subsequent salary entry): Salaries and wages paid are ₺4,000. Of this amount, ₺1,200 applied to accrued salaries and wages payable and ₺2,800 was earned between November 1 and November 9.

Illustration 4A.1 shows the entries with and without reversing entries.

The first three entries are the same whether or not Yazici uses reversing entries. The last two entries are different. The November 1 **reversing entry** eliminates the ₺1,200 balance in Salaries and Wages Payable created by the October 31 adjusting entry. The reversing entry also creates a ₺1,200 credit balance in the Salaries and Wages Expense account. As you know, it is unusual for an expense account to have a credit balance. The balance is correct in this instance, though, because it anticipates that the entire amount of the first salaries and wages payment in the new accounting period will be debited to Salaries and Wages Expense. This debit will eliminate the credit balance. The resulting debit balance in the expense account will equal the salaries and wages expense incurred in the new accounting period (₺2,800 in this example).

If Yazici makes reversing entries, it can debit all cash payments of expenses to the expense account. This means that on November 9 (and every payday) Yazici can debit Salaries and Wages Expense for the amount paid, without regard to any accrued salaries and wages payable. Being able to make the **same entry each time** simplifies the recording process. The company can record subsequent transactions as if the related adjusting entry had never been made.

Illustration 4A.2 shows the posting of the entries with reversing entries.

ILLUSTRATION 4A.1 **Comparative entries—without and with reversing**

Without Reversing Entries (per chapter)

	Initial Salary Entry		
Oct. 26	Salaries and Wages Expense	4,000	
	Cash		4,000
	Adjusting Entry		
Oct. 31	Salaries and Wages Expense	1,200	
	Salaries and Wages Payable		1,200
	Closing Entry		
Oct. 31	Income Summary	5,200	
	Salaries and Wages Expense		5,200
	Reversing Entry		
Nov. 1	No reversing entry is made.		
	Subsequent Salary Entry		
Nov. 9	Salaries and Wages Payable	1,200	
	Salaries and Wages Expense	2,800	
	Cash		4,000

With Reversing Entries (per appendix)

	Initial Salary Entry		
Oct. 26	(Same entry)		
	Adjusting Entry		
Oct. 31	(Same entry)		
	Closing Entry		
Oct. 31	(Same entry)		
	Reversing Entry		
Nov. 1	**Salaries and Wages Payable**	**1,200**	
	Salaries and Wages Expense		**1,200**
	Subsequent Salary Entry		
Nov. 9	**Salaries and Wages Expense**	**4,000**	
	Cash		**4,000**

ILLUSTRATION 4A.2 **Postings with reversing entries**

Salaries and Wages Expense

10/26	Paid	4,000			
31	Adjusting	1,200			
		5,200	10/31	Closing	5,200
11/9	Paid	4,000	**11/1**	**Reversing**	**1,200**

Salaries and Wages Payable

11/1	**Reversing**	**1,200**	10/31	Adjusting	1,2

A company can also use reversing entries for accrued revenue adjusting entries. For Yazici, the adjusting entry was Accounts Receivable (Dr.) 200 and Service Revenue (Cr.) 200. Thus, the reversing entry on November 1 is:

Nov. 1	Service Revenue	200	
	Accounts Receivable		200
	(To reverse October 31 adjusting entry)		

A	=	L	+	E
				–200 Rev
–200				

Cash Flows
no effect

When Yazici collects the accrued service revenue, it debits Cash and credits Service Revenue.

Review and Practice

Learning Objectives Review

1 Prepare a worksheet.

The steps in preparing a worksheet are as follows. (a) Prepare a trial balance on the worksheet. (b) Enter the adjustments in the adjustments columns. (c) Enter adjusted balances in the adjusted trial balance columns. (d) Extend adjusted trial balance amounts to appropriate financial statement columns. (e) Total the statement columns, compute net income (or net loss), and complete the worksheet.

2 Prepare closing entries and a post-closing trial balance.

Closing the books occurs at the end of an accounting period. The process is to journalize and post closing entries and then underline and balance all accounts. In closing the books, companies make separate entries to close revenues and expenses to Income Summary, Income Summary to Retained Earnings, and Dividends to Retained Earnings. Only temporary accounts are closed. A post-closing trial balance contains the balances in permanent accounts that are carried forward to the next accounting period. The purpose of this trial balance is to prove the equality of these balances.

3 Explain the steps in the accounting cycle and how to prepare correcting entries.

The required steps in the accounting cycle are (1) analyze business transactions, (2) journalize the transactions, (3) post to ledger accounts, (4) prepare a trial balance, (5) journalize and post adjusting entries, (6) prepare an adjusted trial balance, (7) prepare financial statements, (8) journalize and post closing entries, and (9) prepare a post-closing trial balance.

One way to determine the correcting entry is to compare the incorrect entry with the correct entry. After comparison, the company makes a correcting entry to correct the accounts. An alternative to a correcting entry is to reverse the incorrect entry and then prepare the correct entry.

4 Identify the sections of a classified statement of financial position.

A classified statement of financial position categorizes assets as intangibles; property, plant, and equipment; long-term investments; and current assets. Liabilities are classified as either non-current or current. There is also an equity section, which varies with the form of business organization.

***5 Prepare reversing entries.**

Reversing entries are the opposite of the adjusting entries made in the preceding period. Some companies choose to make reversing entries at the beginning of a new accounting period to simplify the recording of later transactions related to the adjusting entries. In most cases, only accrued adjusting entries are reversed.

Glossary Review

Classified statement of financial position
A statement of financial position that contains standard classifications or sections.

Closing entries
Entries made at the end of an accounting period to transfer the balances of temporary accounts to a permanent equity account, Retained Earnings.

Correcting entries
Entries to correct errors made in recording transactions.

Current assets
Assets, including cash, investments held for trading purposes, and assets that a company expects to convert to cash or use up within one year or its operating cycle, whichever is longer.

Current liabilities
Obligations related to operations that a company expects to pay within the coming year or its operating cycle, whichever is longer, and obligations related to financing that will be paid in the next year.

Equity
The ownership claims of shareholders on total assets.

Income Summary
A temporary account used in closing revenue and expense accounts.

Intangible assets
Long-lived assets that do not have physical substance.

Liquidity
The ability of a company to pay obligations expected to be due within the next year.

Long-term investments
Generally, (1) investments in shares and bonds of other companies that companies normally hold for many years; (2) non-current assets, such as land and buildings, not currently being used in operating activities; and (3) long-term notes receivable.

Non-current liabilities
Obligations that a company expects to pay after one year.

Operating cycle
The average time that it takes to purchase inventory, sell it on account, and then collect cash from customers.

Permanent (real) accounts
Accounts that relate to one or more future accounting periods. Consist of all statement of financial position accounts. Balances are carried forward to the next accounting period.

Post-closing trial balance
A list of permanent accounts and their balances after a company has journalized and posted closing entries.

Property, plant, and equipment
Assets with relatively long useful lives and currently being used in operations.

Reversing entry
An entry, made at the beginning of the next accounting period that is the exact opposite of the adjusting entry made in the previous period.

Temporary (nominal) accounts
Accounts that relate only to a given accounting period. Consist of all income statement accounts and the Dividends account. All temporary accounts are closed at end of the accounting period.

Worksheet
A multiple-column form that may be used in making adjustments and in preparing financial statements.

Practice Multiple-Choice Questions

1. **(LO 1)** Which of the following statements is **incorrect** concerning the worksheet?

   a. The worksheet is essentially a working tool of the accountant.

   b. The worksheet is distributed to management and other interested parties.

   c. The worksheet cannot be used as a basis for posting to ledger accounts.

   d. Financial statements can be prepared directly from the worksheet before journalizing and posting the adjusting entries.

Solution

2. **(LO 1)** In a worksheet, net income is entered in the following columns:

   a. income statement (Dr) and statement of financial position (Dr).

   b. income statement (Cr) and statement of financial position (Dr).

   c. income statement (Dr) and statement of financial position (Cr).

   d. income statement (Cr) and statement of financial position (Cr).

Solution

3. **(LO 1)** In the unadjusted trial balance of its worksheet for the year ended December 31, 2025, Kim Company reported Equipment of NT$120,000. The year-end adjusting entries require an adjustment of NT$15,000 for depreciation expense for the equipment. After the adjusted trial balance is

completed, what amount should be shown in the financial statement columns?

a. A debit of NT$105,000 for Equipment in the statement of financial position column.

b. A credit of NT$15,000 for Depreciation Expense in the income statement column.

c. A debit of NT$120,000 for Equipment in the statement of financial position column.

d. A debit of NT$15,000 for Accumulated Depreciation—Equipment in the statement of financial position column.

Solution

4. (LO 2) An account that will have a zero balance after closing entries have been journalized and posted is:

a. Service Revenue.

b. Supplies.

c. Prepaid Insurance.

d. Accumulated Depreciation—Equipment.

Solution

5. (LO 2) When a net loss has occurred, Income Summary is:

a. debited and Retained Earnings is credited.

b. credited and Retained Earnings is debited.

c. debited and Dividends is credited.

d. credited and Dividends is debited.

Solution

6. (LO 2) The closing process involves separate entries to close (1) expenses, (2) dividends, (3) revenues, and (4) income summary. The correct sequencing of the entries is:

a. (4), (3), (2), (1).

b. (1), (2), (3), (4).

c. (3), (1), (4), (2).

d. (3), (2), (1), (4).

Solution

7. (LO 2) Which types of accounts will appear in the post-closing trial balance?

a. Permanent (real) accounts.

b. Temporary (nominal) accounts.

c. Accounts shown in the income statement columns of a worksheet.

d. None of these answer choices is correct.

Solution

8. (LO 3) All of the following are required steps in the accounting cycle **except**:

a. journalizing and posting closing entries.

b. preparing financial statements.

c. journalizing the transactions.

d. preparing a worksheet.

Solution

9. (LO 3) The proper order of the following steps in the accounting cycle is:

a. prepare unadjusted trial balance, journalize transactions, post to ledger accounts, journalize and post adjusting entries.

b. journalize transactions, prepare unadjusted trial balance, post to ledger accounts, journalize and post adjusting entries.

c. journalize transactions, post to ledger accounts, prepare unadjusted trial balance, journalize and post adjusting entries.

d. prepare unadjusted trial balance, journalize and post adjusting entries, journalize transactions, post to ledger accounts.

Solution

10. (LO 3) When Lopez Company purchased supplies worth $600, it incorrectly recorded a credit to Supplies for $6,000 and a debit to Cash for $6,000. Before correcting this error:

a. Cash is overstated and Supplies is overstated.

b. Cash is understated and Supplies is understated.

c. Cash is understated and Supplies is overstated.

d. Cash is overstated and Supplies is understated.

Solution

11. (LO 3) Cash of €100 received at the time the service was performed was journalized and posted as a debit to Cash €100 and a credit to Accounts Receivable €100. Assuming the incorrect entry is not reversed, the correcting entry is:

a. debit Service Revenue €100 and credit Accounts Receivable €100.

b. debit Accounts Receivable €100 and credit Service Revenue €100.

c. debit Cash €100 and credit Service Revenue €100.

d. debit Accounts Receivable €100 and credit Cash €100.

Solution

12. (LO 4) The correct order of presentation in a classified statement of financial position for the following current assets is:

a. accounts receivable, cash, prepaid insurance, inventory.

b. prepaid insurance, inventory, accounts receivable, cash.

c. cash, accounts receivable, inventory, prepaid insurance.

d. inventory, cash, accounts receivable, prepaid insurance.

Solution

13. (LO 4) A company has purchased a tract of land. It expects to build a production plant on the land in approximately 5 years. During the 5 years before construction, the land will be idle. The land should be reported as:

a. property, plant, and equipment.

b. land expense.

c. a long-term investment.

d. an intangible asset.

Solution

14. (LO 4) In a classified statement of financial position, assets and liabilities are usually shown in the following order:

a. current assets, current liabilities, non-current liabilities, and non-current assets.

b. non-current liabilities, current liabilities, current assets, and non-current assets.

c. non-current liabilities, non-current assets, current liabilities, and non-current assets.

d. non-current assets, current assets, non-current liabilities, and current liabilities.

Solution

15. (LO 4) Current assets are listed:

a. in the reverse order of expected conversion to cash.

b. by importance.

c. by longevity.

d. by size.

Solution

*16. (LO 5) On December 31, Kohl Company correctly made an adjusting entry to recognize $2,000 of accrued salaries payable. On January 8 of the next year, total salaries of $3,800 were paid. Assuming the correct reversing entry was made on January 1, the entry on January 8 will result in a credit to Cash $3,800 and the following debit(s):

a. Salaries and Wages Payable $1,800 and Salaries and Wages Expense $2,000.

b. Salaries and Wages Payable $2,000 and Salaries and Wages Expense $1,800.

c. Salaries and Wages Expense $3,800.

d. Salaries and Wages Payable $3,800.

Solution

Practice Brief Exercises

Prepare closing entries from ledger balances.

1. (LO 2) The ledger of Xi Travel contains the following balances (amounts in thousands): Retained Earnings ¥40,000, Dividends ¥3,000, Service Revenue ¥65,000, Salaries and Wages Expense ¥39,000, and Maintenance and Repairs Expense ¥9,000. Prepare the closing entries at December 31.

Solution

Prepare correcting entries.

2. (LO 3) At Shields Pharmaceuticals, the following errors were discovered after the transactions had been journalized and posted. Prepare the correcting entries.

a. A cash sale to a customer for €780 was recorded as a debit to Cash €780 and a credit to Accounts Receivable €780.

b. The purchase of equipment on account for €1,730 was recorded as a debit to Equipment €1,370 and a credit to Accounts Payable €1,370.

Solution

Prepare the current assets section of a statement of financial position.

3. (LO 4) The statement of financial position debit column of the worksheet for Soon Cosmetics includes the following accounts (amounts in thousands): Accounts Receivable ₩25,000, Prepaid Insurance ₩7,000, Cash ₩8,000, Supplies ₩11,000, and Inventory ₩14,000. Prepare the current assets section of the statement of financial position, listing the accounts in proper sequence.

Solution

Practice Exercises

Journalize and post closing entries, and prepare a post-closing trial balance.

1. (LO 2) Hercules Company ended its fiscal year on August 31, 2025. The company's adjusted trial balance as of the end of its fiscal year is shown as follows.

Hercules Company
Adjusted Trial Balance
August 31, 2025

No.	Account Titles	Debit	Credit
101	Cash	€10,900	
112	Accounts Receivable	6,200	
157	Equipment	10,600	
167	Accumulated Depr.—Equip.		€ 5,400
201	Accounts Payable		2,800
208	Unearned Rent Revenue		1,200
311	Share Capital—Ordinary		3,000
320	Retained Earnings		28,700
332	Dividends	12,000	
404	Service Revenue		42,400
429	Rent Revenue		6,100
711	Depreciation Expense	2,700	
720	Salaries and Wages Expense	37,100	
732	Utilities Expense	10,100	
		€89,600	€89,600

Instructions

a. Prepare the closing entries using page J15 in a general journal.

b. Post to Retained Earnings and No. 350 Income Summary accounts. (Use the three-column form.)

c. Prepare a post-closing trial balance at August 31, 2025.

Solution

Prepare financial statements.

2. (LO 4) The adjusted trial balance for Hercules Company is presented in **Practice Exercise 1**.

Instructions

a. Prepare an income statement and a retained earnings statement for the year ended August 31, 2025.

b. Prepare a classified statement of financial position at August 31, 2025.

Solution

Practice Problem

Prepare worksheet and classified statement of financial position, and journalize closing entries.

(LO 1, 2, 4) At the end of its first month of operations, Pampered Pet Service has the following unadjusted trial balance.

Pampered Pet Service
August 31, 2025
Trial Balance

	Debit	Credit
Cash	NT$ 5,400	
Accounts Receivable	2,800	
Supplies	1,300	
Prepaid Insurance	2,400	
Equipment	60,000	
Notes Payable		NT$40,000
Accounts Payable		2,400
Share Capital—Ordinary		30,000
Dividends	1,000	
Service Revenue		4,900
Salaries and Wages Expense	3,200	
Utilities Expense	800	
Advertising Expense	400	
	NT$77,300	NT$77,300

Other data:

1. Insurance expires at the rate of NT$200 per month.
2. NT$1,000 of supplies are on hand at August 31.
3. Monthly depreciation on the equipment is NT$900.
4. Interest of NT$500 on the notes payable has accrued during August.

Instructions

a. Prepare a worksheet.

b. Prepare a classified statement of financial position assuming NT$35,000 of the notes payable are long-term.

c. Journalize the closing entries.

Solution

Note: All asterisked Questions, Exercises, and Problems relate to material in the appendix to the chapter.

Questions

1. "A worksheet is a permanent accounting record and its use is required in the accounting cycle." Do you agree? Explain.

2. Explain the purpose of the worksheet.

3. What is the relationship, if any, between the amount shown in the adjusted trial balance column for an account and that account's ledger balance?

4. If a company's revenues are ¥125,000 and its expenses are ¥113,000, in which financial statement columns of the worksheet will the net income of ¥12,000 appear? When expenses exceed revenues, in which columns will the difference appear?

5. Why is it necessary to prepare formal financial statements if all of the data are in the statement columns of the worksheet?

6. Identify the account(s) debited and credited in each of the four closing entries, assuming the company has net income for the year.

7. Describe the nature of the Income Summary account and identify the types of summary data that may be posted to this account.

8. What are the content and purpose of a post-closing trial balance?

9. Which of the following accounts would not appear in the post-closing trial balance? Interest Payable, Equipment, Depreciation Expense, Dividends, Unearned Service Revenue, Accumulated Depreciation—Equipment, and Service Revenue.

10. Distinguish between a reversing entry and an adjusting entry. Are reversing entries required?

11. Indicate, in the sequence in which they are made, the three required steps in the accounting cycle that involve journalizing.

12. Identify, in the sequence in which they are prepared, the three trial balances that are used in the accounting cycles.

13. How do correcting entries differ from adjusting entries?

14. What standard classifications are used in preparing a classified statement of financial position?

15. What is meant by the term "operating cycle"?

16. Define current assets. What basis is used for arranging individual items within the current assets section?

17. Distinguish between long-term investments and property, plant, and equipment.

18. (a) What is the term used to describe the equity section of a corporation? (b) Identify the two equity accounts in a corporation and indicate the purpose of each.

19. Using **TSMC**'s annual report, determine its current liabilities at December 31, 2019, and December 31, 2020. Were current liabilities higher or lower than current assets in these two years?

***20.** Cigale Company prepares reversing entries. If the adjusting entry for interest payable is reversed, what type of an account balance, if any, will there be in Interest Payable and Interest Expense after the reversing entry is posted?

***21.** At December 31, accrued salaries payable totaled €3,500. On January 10, total salaries of €8,000 are paid. (a) Assume that reversing entries are made at January 1. Give the January 10 entry, and indicate the Salaries and Wages Expense account balance after the entry is posted. (b) Repeat part (a) assuming reversing entries are not made.

Brief Exercises

List the steps in preparing a worksheet.

BE4.1 (LO 1) The steps in using a worksheet are presented in random order below. List the steps in the proper order by placing numbers 1–5 in the blank spaces.

a. _____ Prepare a trial balance on the worksheet.

b. _____ Enter adjusted balances.

c. _____ Extend adjusted balances to appropriate statement columns.

d. _____ Total the statement columns, compute net income (loss), and complete the worksheet.

e. _____ Enter adjustment data.

Prepare partial worksheet.

BE4.2 (LO 1) The ledger of Walters Repair Shop includes the following unadjusted balances: Prepaid Insurance €3,000, Service Revenue €60,000, and Salaries and Wages Expense €25,000. Adjusting entries are required for (a) expired insurance €1,800; (b) services performed €1,100 are billed and not yet collected; and (c) accrued salaries payable €900. Enter the unadjusted balances and adjustments into a worksheet and complete the worksheet for all accounts. (*Note:* You will need to add the following accounts: Accounts Receivable, Salaries and Wages Payable, and Insurance Expense.)

Identify worksheet columns for selected accounts.

BE4.3 (LO 1) The following selected accounts appear in the adjusted trial balance columns of the worksheet for Lee Company: Accumulated Depreciation, Depreciation Expense, Share Capital—Ordinary, Dividends, Service Revenue, Supplies, and Accounts Payable. Indicate the financial statement column (income statement Dr., statement of financial position Cr., etc.) to which each balance should be extended.

Prepare closing entries from ledger balances.

BE4.4 (LO 2) The ledger of Desai Catering contains the following balances: Retained Earnings ₹30,000, Dividends ₹2,000, Service Revenue ₹58,000, Salaries and Wages Expense ₹39,000, and Supplies Expense ₹7,000. Prepare the closing entries at December 31.

Post closing entries; underline and balance T-accounts.

BE4.5 (LO 2) Using the data in BE4.4, enter the balances in T-accounts, post the closing entries, and underline and balance the accounts.

Journalize and post closing entries using the three-column form of account.

BE4.6 (LO 2) The income statement for Golden Golf Club for the month ending July 31 shows Service Revenue ¥17,800, Salaries and Wages Expense ¥9,600, Maintenance and Repairs Expense ¥2,500, and Net Income ¥5,700. Prepare the entries to close the revenue and expense accounts. Post the entries to the revenue and expense accounts, and complete the closing process for these accounts using the three-column form of account (amounts in thousands).

Identify post-closing trial balance accounts.

BE4.7 (LO 2) Using the data in BE4.3, identify the accounts that would be included in a post-closing trial balance.

List the required steps in the accounting cycle in sequence.

BE4.8 (LO 3) The steps in the accounting cycle are listed in random order below. List the steps in proper sequence, assuming no worksheet is prepared, by placing numbers 1–9 in the blank spaces.

a. _____ Prepare a trial balance.

b. _____ Journalize the transactions.

c. _____ Journalize and post closing entries.

d. _____ Prepare financial statements.

e. _____ Journalize and post adjusting entries.

f. _____ Post to ledger accounts.

g. _____ Prepare a post-closing trial balance.

h. _____ Prepare an adjusted trial balance.

i. _____ Analyze business transactions.

Prepare correcting entries.

BE4.9 (LO 3) At Raymond Ltd., the following errors were discovered after the transactions had been journalized and posted. Prepare the correcting entries.

1. A collection on account from a customer for £870 was recorded as a debit to Cash £870 and a credit to Service Revenue £870.
2. The purchase of store supplies on account for £1,510 was recorded as a debit to Supplies £1,150 and a credit to Accounts Payable £1,150.

Prepare the current assets section of a statement of financial position.

BE4.10 (LO 4) The statement of financial position debit column of the worksheet for Jolie Company includes the following accounts: Accounts Receivable $12,500, Prepaid Insurance $4,500, Cash $4,100, Supplies $5,200, and Debt Investments (short-term) $7,600. Prepare the current assets section of the statement of financial position, listing the accounts in proper sequence.

Classify accounts on statement of financial position.

BE4.11 (LO 4) The following are the major statement of financial position classifications:

Intangible assets (IA)	Equity (E)
Property, plant, and equipment (PPE)	Non-current liabilities (NCL)
Long-term investments (LTI)	Current liabilities (CL)
Current assets (CA)	

Match each of the following accounts to its proper statement of financial position classification.

_____ Accounts payable	_____ Income taxes payable
_____ Accounts receivable	_____ Debt investments (long-term)
_____ Accumulated depreciation—buildings	_____ Land
_____ Buildings	_____ Inventory

_____ Cash
_____ Copyrights
_____ Patents
_____ Supplies

Prepare reversing entries.

***BE4.12 (LO 5)** At October 31, Miras Transportation made an accrued expense adjusting entry of €3,300 for salaries. Prepare the reversing entry on November 1, and indicate the balances in Salaries and Wages Payable and Salaries and Wages Expense after posting the reversing entry.

DO IT! Exercises

Prepare a worksheet.

DO IT! 4.1 (LO 1) Jordan Carr is preparing a worksheet. Explain to Jordan how he should extend the following adjusted trial balance accounts to the financial statement columns of the worksheet.

Service Revenue	Accounts Receivable
Notes Payable	Accumulated Depreciation
Share Capital—Ordinary	Utilities Expense

Prepare closing entries.

DO IT! 4.2 (LO 2) Paloma Grooming shows the following balances in selected accounts of its adjusted trial balance (amounts in thousands).

Supplies	Rp32,000	Service Revenue	Rp108,000
Supplies Expense	6,000	Salaries and Wages Expense	40,000
Accounts Receivable	12,000	Utilities Expense	8,000
Dividends	22,000	Rent Expense	18,000
Share Capital—Ordinary	70,000		

Prepare the closing entries at December 31.

Prepare correcting entries.

DO IT! 4.3 (LO 3) Hanson Stables has an inexperienced accountant. During the first month on the job, the accountant made the following errors in journalizing transactions. All entries were posted as made.

1. The purchase of supplies for €650 cash was debited to Equipment €210 and credited to Cash €210.
2. A €500 cash dividend was debited to Salaries and Wages Expense €900 and credited to Cash €900.
3. A payment on account of €820 to a creditor was debited to Accounts Payable €280 and credited to Cash €280.

Prepare the correcting entries.

Match accounts to statement of financial position classifications.

DO IT! 4.4 (LO 4) The following accounts were taken from the financial statements of Giles Company.

_____ Interest revenue
_____ Utilities payable
_____ Accounts payable
_____ Supplies
_____ Bonds payable
_____ Goodwill
_____ Share capital—ordinary
_____ Accumulated depreciation—equipment
_____ Equipment
_____ Salaries and wages expense
_____ Debt investments (long-term)
_____ Unearned rent revenue

Match each of the accounts to its proper statement of financial position classification, as shown below. If the item would not appear on a statement of financial position, use "NA."

Intangible assets (IA)	Equity (E)
Property, plant, and equipment (PPE)	Non-current liabilities (NCL)
Long-term investments (LTI)	Current liabilities (CL)
Current assets (CA)	

Exercises

Complete the worksheet.

E4.1 (LO 1) The trial balance columns of the worksheet for Lim Acupuncture at June 30, 2025, are as follows (amounts in thousands).

Lim Acupuncture
Worksheet
For the Month Ended June 30, 2025

	Trial Balance	
Account Titles	**Dr.**	**Cr.**
Cash	2,320	
Accounts Receivable	2,440	
Supplies	1,880	
Accounts Payable		1,120
Unearned Service Revenue		240
Share Capital—Ordinary		3,600
Service Revenue		2,400
Salaries and Wages Expense	560	

Lim Acupuncture Worksheet For the Month Ended June 30, 2025		
	Trial Balance	
Account Titles	Dr.	Cr.
Miscellaneous Expense	160	
	7,360	7,360

Other data:

1. A physical count reveals HK$500 of supplies on hand.
2. HK$100 of the unearned revenue is still unearned at month-end.
3. Accrued salaries are HK$210.

Instructions

Enter the trial balance on a worksheet and complete the worksheet.

Complete the worksheet.

E4.2 (LO 1) The adjusted trial balance columns of the worksheet for Tai Interiors are as follows (amounts in NT$).

Tai Interiors Worksheet (partial) For the Month Ended April 30, 2025						
	Adjusted Trial Balance		Income Statement		Statement of Financial Position	
Account Titles	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	10,000					
Accounts Receivable	7,840					
Prepaid Rent	2,280					
Equipment	23,050					
Accumulated Depreciation—Equip.		4,900				
Notes Payable		5,700				
Accounts Payable		4,920				
Share Capital—Ordinary		25,960				
Dividends	3,650					
Service Revenue		17,590				
Salaries and Wages Expense	10,840					
Rent Expense	760					
Depreciation Expense	650					
Interest Expense	57					
Interest Payable		57				
Totals	59,127	59,127				

Instructions

Complete the worksheet.

Prepare financial statements from worksheet.

E4.3 (LO 1, 4) Worksheet data for Tai Interiors are presented in E4.2.

Instructions

Prepare an income statement, a retained earnings statement, and a classified statement of financial position.

Journalize and post closing entries and prepare a post-closing trial balance.

E4.4 (LO 2) Worksheet data for Tai Interiors are presented in E4.2.

Instructions

a. Journalize the closing entries at April 30.

b. Post the closing entries to Income Summary and Retained Earnings. Use T-accounts.

c. Prepare a post-closing trial balance at April 30.

Prepare adjusting entries from a worksheet, and extend balances to worksheet columns.

E4.5 (LO 1) The adjustments columns of the worksheet for Becker Company are shown below.

Account Titles	Adjustments	
	Debit	Credit
Accounts Receivable	1,100	
Prepaid Insurance		300
Accumulated Depreciation—Equipment		900
Salaries and Wages Payable		500
Service Revenue		1,100
Salaries and Wages Expense	500	
Insurance Expense	300	
Depreciation Expense	900	
	2,800	2,800

Instructions

a. Prepare the adjusting entries.

b. Assuming the adjusted trial balance amount for each account is normal, indicate the financial statement column to which each balance should be extended.

Derive adjusting entries from worksheet data.

E4.6 (LO 1) Selected worksheet data for Wong Landscaping are presented below.

Account Titles	Trial Balance		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.
Accounts Receivable	?		34,000	
Prepaid Insurance	26,000		20,000	
Supplies	7,000		?	
Accumulated Depreciation—Equipment		12,000		?
Salaries and Wages Payable		?		5,600
Service Revenue		88,000		97,000
Insurance Expense			?	
Depreciation Expense			10,000	
Supplies Expense			4,500	
Salaries and Wages Expense	?		49,000	

Instructions

a. Fill in the missing amounts (all amounts in ¥).

b. Prepare the adjusting entries that were made.

Prepare closing entries, and prepare a post-closing trial balance.

E4.7 (LO 2) Je Ju Consultants had the following adjusted trial balance (amounts in thousands).

Je Ju Consultants
Adjusted Trial Balance
For the Month Ended June 30, 2025

Account Titles	Adjusted Trial Balance	
	Debit	Credit
Cash	₩ 3,712	
Accounts Receivable	3,904	
Supplies	480	
Accounts Payable		₩ 1,382
Unearned Service Revenue		160
Share Capital—Ordinary		4,100
Retained Earnings		1,660
Dividends	550	
Service Revenue		4,300
Salaries and Wages Expense	1,260	
Miscellaneous Expense	256	
Supplies Expense	1,900	
Salaries and Wages Payable		460
	₩12,062	₩12,062

Instructions

a. Prepare closing entries at June 30, 2025.

b. Prepare a post-closing trial balance.

Journalize and post closing entries, and prepare a post-closing trial balance.

E4.8 (LO 2) Huang Automotive ended its fiscal year on July 31, 2025. The company's adjusted trial balance as of the end of its fiscal year is as follows.

Huang Automotive
Adjusted Trial Balance
July 31, 2025

No.	Account Titles	Debit	Credit
101	Cash	NT$ 9,840	
112	Accounts Receivable	8,780	
157	Equipment	15,900	
158	Accumulated Depreciation—Equip.		NT$ 7,400
201	Accounts Payable		4,220
208	Unearned Rent Revenue		1,800
311	Share Capital—Ordinary		20,000
320	Retained Earnings		25,200
332	Dividends	16,000	
400	Service Revenue		64,000
429	Rent Revenue		6,500
711	Depreciation Expense	8,000	
726	Salaries and Wages Expense	55,700	
732	Utilities Expense	14,900	
		NT$129,120	NT$129,120

Instructions

a. Prepare the closing entries using page J15.

b. Post to Retained Earnings and No. 350 Income Summary accounts. (Use the three-column form.)

c. Prepare a post-closing trial balance at July 31.

Prepare financial statements.

E4.9 (LO 4) The adjusted trial balance for Huang Automotive is presented in E4.8.

Instructions

a. Prepare an income statement and a retained earnings statement for the year.

b. Prepare a classified statement of financial position at July 31.

Answer questions related to the accounting cycle.

E4.10 (LO 3) Ji-a Cho has prepared the following list of statements about the accounting cycle.

1. "Journalize the transactions" is the first step in the accounting cycle.
2. Reversing entries are a required step in the accounting cycle.
3. Correcting entries do not have to be part of the accounting cycle.
4. If a worksheet is prepared, some steps of the accounting cycle are incorporated into the worksheet.
5. The accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance.
6. All steps of the accounting cycle occur daily during the accounting period.
7. The step of "post to the ledger accounts" occurs before the step of "journalize the transactions."
8. Closing entries must be prepared before financial statements can be prepared.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Prepare closing entries.

E4.11 (LO 2) Selected accounts for Tamora's Salon are presented below. All June 30 postings are from closing entries.

Salaries and Wages Expense

6/10	3,200		
6/28	5,600		
Bal.	8,800	6/30	8,800

Service Revenue

		6/15	9,700
		6/24	8,400
6/30	18,100	Bal.	18,100

Retained Earnings

6/30	2,500	6/1	12,000
		6/30	5,000
		Bal.	14,500

Supplies Expense

6/12	600		
6/24	700		
Bal.	1,300	6/30	1,300

Rent Expense

6/1	3,000		
Bal.	3,000	6/30	3,000

Dividends

6/13	1,000		
6/25	1,500		
Bal.	2,500	6/30	2,500

Instructions

a. Prepare the closing entries that were made.

b. Post the closing entries to Income Summary.

Prepare correcting entries.

E4.12 (LO 3) Natt Spa discovered the following errors made in January 2025.

1. A payment of Salaries and Wages Expense of €700 was debited to Equipment and credited to Cash, both for €700.
2. A collection of €1,500 from a client on account was debited to Cash €150 and credited to Service Revenue €150.
3. The purchase of equipment on account for €670 was debited to Equipment €760 and credited to Accounts Payable €760.

Instructions

a. Correct the errors by reversing the incorrect entry and preparing the correct entry.

b. Correct the errors without reversing the incorrect entry.

Prepare correcting entries.

E4.13 (LO 3) Patel Company has an inexperienced accountant. During the first 2 weeks on the job, the accountant made the following errors in journalizing transactions. All entries were posted as made.

1. A payment on account of $750 to a creditor was debited to Accounts Payable $570 and credited to Cash $570.
2. The purchase of supplies on account for $560 was debited to Equipment $56 and credited to Accounts Payable $56.
3. A $500 cash dividend was debited to Salaries and Wages Expense $500 and credited to Cash $500.

Instructions

Prepare the correcting entries.

Prepare a classified statement of financial position.

E4.14 (LO 4) Writing The adjusted trial balance for Tsai Bowling Alley at December 31, 2025, contains the following accounts (amounts in thousands).

	Debit		Credit
Buildings	¥128,800	Share Capital—Ordinary	¥100,000
Accounts Receivable	14,520	Retained Earnings	13,000
Prepaid Insurance	4,680	Accumulated Depreciation—Buildings	42,600
Cash	18,040	Accounts Payable	12,300
Equipment	62,400	Notes Payable	97,780
Land	65,000	Accumulated Depreciation—Equipment	18,720
Insurance Expense	780	Interest Payable	3,800
Depreciation Expense	7,360	Service Revenue	17,180
Interest Expense	3,800		¥305,380
	¥305,380		

Instructions

a. Prepare a classified statement of financial position; assume that ¥30,000 of the note payable will be paid in 2026.

b. Comment on the liquidity of the company.

Classify accounts on statement of financial position.

E4.15 (LO 4) The following are the major statement of financial position classifications.

Intangible assets (IA)	Equity (E)
Property, plant, and equipment (PPE)	Non-current liabilities (NCL)
Long-term investments (LTI)	Current liabilities (CL)
Current assets (CA)	

Instructions

Classify each of the following accounts taken from Faust Company's statement of financial position.

_____ Accounts payable
_____ Accounts receivable
_____ Cash
_____ Share capital—ordinary
_____ Patents
_____ Salaries and wages payable
_____ Inventory
_____ Share investments (to be sold in 7 months)
_____ Accumulated depreciation—equipment
_____ Buildings
_____ Land (in use)
_____ Notes payable (due in 2 years)
_____ Supplies
_____ Equipment
_____ Prepaid expenses

Prepare a classified statement of financial position.

E4.16 (LO 4) The following items were taken from the financial statements of J. Kung Enterprises. (All amounts are in thousands.)

Long-term debt	HK$ 1,000	Accumulated depreciation—equipment	HK$ 5,655
Prepaid insurance	650	Accounts payable	1,214
Equipment	11,500	Notes payable (due after 2026)	400
Share investments (long-term)	264	Share capital—ordinary	11,455
Debt investments (short-term)	3,690	Retained earnings	1,500
Notes payable (due in 2026)	500	Accounts receivable	1,696
Cash	2,668	Inventory	1,256

Instructions

Prepare a classified statement of financial position in good form as of December 31, 2025.

Prepare financial statements.

E4.17 (LO 4) These financial statement items are for Basten Tax Services at year-end, July 31, 2025.

Salaries and wages payable	£ 2,080	Notes payable (long-term)	£ 1,800
Salaries and wages expense	48,700	Cash	14,200
Utilities expense	22,600	Accounts receivable	9,780
Equipment	34,400	Accumulated depreciation—equipment	6,000
Accounts payable	4,100	Dividends	3,000
Service revenue	63,000	Depreciation expense	4,000
Rent revenue	8,500	Retained earnings (beginning of the year)	31,200
Share capital—ordinary	20,000		

Instructions

a. Prepare an income statement and a retained earnings statement for the year.

b. Prepare a classified statement of financial position at July 31.

Use reversing entries.

***E4.18 (LO 5)** Krantz Company pays salaries of $12,000 every Monday for the preceding 5-day week (Monday through Friday). Assume December 31 falls on a Tuesday, so Krantz's employees have worked 2 days without being paid at the end of the fiscal year.

Instructions

a. Assume the company does not use reversing entries. Prepare the December 31 adjusting entry and the entry on Monday, January 6, when Krantz pays the payroll.

b. Assume the company does use reversing entries. Prepare the December 31 adjusting entry, the January 1 reversing entry, and the entry on Monday, January 6, when Krantz pays the payroll.

Prepare closing and reversing entries.

***E4.19 (LO 2, 5)** On December 31, the adjusted trial balance of Shihata Employment Agency shows the following selected data.

Accounts Receivable	NT$24,500	Service Revenue	NT$92,500
Interest Expense	7,700	Interest Payable	2,200

Analysis shows that adjusting entries were made to (1) accrue NT$5,000 of service revenue and (2) accrue NT$2,200 interest expense.

Instructions

a. Prepare the closing entries for the temporary accounts shown above at December 31.

b. Prepare the reversing entries on January 1.

c. Post the entries in (a) and (b). Underline and balance the accounts. (Use T-accounts.)

d. Prepare the entries to record (1) the collection of the accrued revenue on January 10 and (2) the payment of all interest due (NT$3,000) on January 15.

e. Post the entries in (d) to the temporary accounts.

Problems

Prepare a worksheet, financial statements, and adjusting and closing entries.

P4.1 (LO 1, 2, 4) The trial balance columns of the worksheet for Wang Roofing at March 31, 2025, are as follows (amounts in thousands).

Wang Roofing
Worksheet
For the Month Ended March 31, 2025

	Trial Balance	
Account Titles	**Dr.**	**Cr.**
Cash	4,500	
Accounts Receivable	3,200	
Supplies	2,000	
Equipment	11,000	
Accumulated Depreciation—Equipment		1,250
Accounts Payable		2,500
Unearned Service Revenue		550
Share Capital—Ordinary		12,900
Dividends	1,100	
Service Revenue		6,300
Salaries and Wages Expense	1,300	
Miscellaneous Expense	400	
	23,500	23,500

Other data:

1. A physical count reveals only ¥480 of roofing supplies on hand.
2. Depreciation for March is ¥250.
3. Unearned revenue amounted to ¥260 at March 31.
4. Accrued salaries are ¥700.

Instructions

a. Enter the trial balance on a worksheet and complete the worksheet.

a. Adjusted trial balance ¥24,450

b. Prepare an income statement and a retained earnings statement for the month of March and a classified statement of financial position at March 31.

b. Net income ¥2,420

Total assets ¥17,680

c. Journalize the adjusting entries from the adjustments columns of the worksheet.

d. Journalize the closing entries from the financial statement columns of the worksheet.

Complete worksheet; prepare financial statements, closing entries, and post-closing trial balance.

P4.2 (LO 1, 2, 4) The adjusted trial balance columns of the worksheet for Nguyen Company are as follows.

Nguyen Company
Worksheet
For the Year Ended December 31, 2025

Account No.	Account Titles	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.
101	Cash	5,300	
112	Accounts Receivable	10,800	
126	Supplies	1,500	
130	Prepaid Insurance	2,000	
157	Equipment	27,000	
158	Accumulated Depreciation—Equipment		5,600
200	Notes Payable		15,000
201	Accounts Payable		6,100
212	Salaries and Wages Payable		3,600
230	Interest Payable		600
311	Share Capital—Ordinary		11,000
320	Retained Earnings		2,000
332	Dividends	7,600	
400	Service Revenue		61,000
610	Advertising Expense	9,000	
631	Supplies Expense	4,000	
711	Depreciation Expense	5,600	
722	Insurance Expense	3,500	
726	Salaries and Wages Expense	28,000	
905	Interest Expense	600	
	Totals	104,900	104,900

Instructions

a. Complete the worksheet by extending the balances to the financial statement columns.

a. Net income $10,300

b. Prepare an income statement, a retained earnings statement, and a classified statement of financial position. (*Note:* $4,000 of the notes payable become due in 2026.)

b. Current assets $19,600 Current liabilities $14,300

c. Prepare the closing entries. Use J14 for the journal page.

d. Post the closing entries. Use the three-column form of account. Income Summary is No. 350.

e. Prepare a post-closing trial balance.

e. Post-closing trial balance $46,600

Prepare financial statements, closing entries, and post-closing trial balance.

P4.3 (LO 1, 2, 4) The completed financial statement columns of the worksheet for Bray Music are shown as follows (amounts in NT$).

Bray Music
Worksheet
For the Year Ended December 31, 2025

Account No.	Account Titles	Income Statement		Statement of Financial Position	
		Dr.	Cr.	Dr.	Cr.
101	Cash			8,800	
112	Accounts Receivable			10,800	
130	Prepaid Insurance			2,800	
157	Equipment			24,000	
158	Accumulated Depreciation—Equip.				4,200
201	Accounts Payable				9,000
212	Salaries and Wages Payable				2,400
311	Share Capital—Ordinary				15,000
320	Retained Earnings				4,500
332	Dividends			11,000	
400	Service Revenue		60,000		
622	Maintenance and Repairs Expense	1,700			
711	Depreciation Expense	2,800			
722	Insurance Expense	1,800			
726	Salaries and Wages Expense	30,000			
732	Utilities Expense	1,400			
	Totals	37,700	60,000	57,400	35,100
	Net Income	22,300			22,300
		60,000	60,000	57,400	57,400

Instructions

a. Prepare an income statement, a retained earnings statement, and a classified statement of financial position.

a. Ending retained earnings NT$15,800

Total current assets NT$22,400

b. Prepare the closing entries.

c. Post the closing entries and underline and balance the accounts. (Use T-accounts.) Income Summary is account No. 350.

d. Prepare a post-closing trial balance.

d. Post-closing trial balance NT$46,400

Complete worksheet; prepare classified statement of financial position, entries, and post-closing trial balance.

P4.4 (LO 1, 2, 4) Rusthe Management Services began business on January 1, 2025, with a capital investment of $120,000. The company manages condominiums for owners (Service Revenue) and rents space in its own office building (Rent Revenue). The trial balance and adjusted trial balance columns of the worksheet at the end of the first year are as follows (amounts in $).

Rusthe Management Services
Worksheet
For the Year Ended December 31, 2025

Account Titles	Trial Balance Dr.	Trial Balance Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.
Cash	13,800		13,800	
Accounts Receivable	28,300		28,300	
Prepaid Insurance	3,600		2,100	
Land	67,000		67,000	
Buildings	127,000		127,000	
Equipment	59,000		59,000	
Accounts Payable		12,500		12,500
Unearned Rent Revenue		6,000		1,000
Mortgage Payable		120,000		120,000
Share Capital—Ordinary		130,000		130,000
Retained Earnings		14,000		14,000
Dividends	22,000		22,000	
Service Revenue		90,700		90,700
Rent Revenue		29,000		34,000
Salaries and Wages Expense	42,000		42,000	
Advertising Expense	20,500		20,500	
Utilities Expense	19,000		19,000	
Totals	402,200	402,200		
Insurance Expense			1,500	
Depreciation Expense			6,600	
Accumulated Depreciation—Buildings				3,000
Accumulated Depreciation—Equipment				3,600
Interest Expense			10,000	
Interest Payable				10,000
Totals			418,800	418,800

Instructions

a. Prepare a complete worksheet.

a. Net income $25,100

b. Prepare a classified statement of financial position. (*Note:* $45,000 of the mortgage note payable is due for payment next year.)

b. Total current assets $44,200

c. Journalize the adjusting entries.

d. Journalize the closing entries.

e. Prepare a post-closing trial balance.

e. Post-closing trial balance $297,200

Complete all steps in accounting cycle.

P4.5 (LO 1, 2, 4) Anya Clark opened Anya's Cleaning Service on July 1, 2025. During July, the following transactions were completed.

July	1	Shareholders invested €20,000 cash in the business in exchange for ordinary shares.
	1	Purchased used truck for €12,000, paying €4,000 cash and the balance on account.
	3	Purchased cleaning supplies for €2,100 on account.
	5	Paid €1,800 cash on a 1-year insurance policy effective July 1.
	12	Billed customers €4,500 for cleaning services.
	18	Paid €1,500 cash on amount owed on truck and €1,400 on amount owed on cleaning supplies.
	20	Paid €2,800 cash for employee salaries.
	21	Collected €3,400 cash from customers billed on July 12.
	25	Billed customers €6,000 for cleaning services.
	31	Paid €350 for the monthly gasoline bill for the truck.
	31	Declared and paid a €5,600 cash dividend.

The chart of accounts for Anya's Cleaning Service contains the following accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 126 Supplies, No. 130 Prepaid Insurance, No. 157 Equipment, No. 158 Accumulated Depreciation—Equipment, No. 201 Accounts Payable, No. 212 Salaries and Wages Payable, No. 311 Share Capital—Ordinary, No. 320 Retained Earnings, No. 332 Dividends, No. 350 Income Summary, No. 400 Service Revenue, No. 631 Supplies Expense, No. 633 Gasoline Expense, No. 711 Depreciation Expense, No. 722 Insurance Expense, and No. 726 Salaries and Wages Expense.

Instructions

a. Journalize and post the July transactions. Use page J1 for the journal and the three-column form of account.

b. Prepare a trial balance at July 31 on a worksheet.

b. Trial balance €37,700

c. Enter the following adjustments on the worksheet and complete the worksheet.

1. Unbilled and uncollected revenue for services performed at July 31 were €2,700.
2. Depreciation on equipment for the month was €500.
3. One-twelfth of the insurance expired.
4. An inventory count shows €600 of cleaning supplies on hand at July 31.
5. Accrued but unpaid employee salaries were €1,000.

c. Adjusted trial balance €41,900

d. Prepare the income statement and a retained earnings statement for July and a classified statement of financial position at July 31.

d. Net income €6,900 Total assets €29,500

e. Journalize and post adjusting entries. Use page J2 for the journal.

f. Journalize and post closing entries and complete the closing process. Use page J3 for the journal.

g. Prepare a post-closing trial balance at July 31.

g. Post-closing trial balance €30,000

Analyze errors and prepare correcting entries and trial balance.

P4.6 (LO 3) Horace Culpepper, CA, was retained by Pulsar Cable to prepare financial statements for April 2025. Horace accumulated all the ledger balances per Pulsar's records and found the following.

Pulsar Cable
Trial Balance
April 30, 2025

	Debit	Credit
Cash	£ 4,100	
Accounts Receivable	3,200	
Supplies	800	
Equipment	10,800	
Accumulated Depreciation—Equip.		£ 1,350
Accounts Payable		2,100
Salaries and Wages Payable		700
Unearned Service Revenue		890
Share Capital—Ordinary		10,100
Retained Earnings		2,800
Service Revenue		5,650
Salaries and Wages Expense	3,300	
Advertising Expense	600	
Miscellaneous Expense	290	
Depreciation Expense	500	
	£23,590	£23,590

Horace Culpepper found the following errors.

1. Cash received from a customer on account was recorded as £950 instead of £590.
2. A payment of £75 for advertising expense was entered as a debit to Miscellaneous Expense £75 and a credit to Cash £75.
3. The first salary payment this month was for £1,900, which included £700 of salaries and wages payable on March 31. The payment was recorded as a debit to Salaries and Wages Expense £1,900 and a credit to Cash £1,900. (No reversing entries were made on April 1.)
4. The purchase on account of a printer costing £310 was recorded as a debit to Supplies and a credit to Accounts Payable for £310.
5. A cash payment of repair expense on equipment for £96 was recorded as a debit to Equipment £69 and a credit to Cash £69.

Instructions

a. Prepare an analysis of each error showing (1) the incorrect entry, (2) the correct entry, and (3) the correcting entry. Items 4 and 5 occurred on April 30, 2025.

b. Prepare a correct trial balance.

b. Trial balance £22,890

Comprehensive Accounting Cycle Review

Complete all steps in accounting cycle.

ACR4.1 Jaden Li opened Kleene Window Washing on July 1, 2025. During July, the following transactions were completed.

July	1	Shareholders invested NT$12,000 cash in the business in exchange for ordinary shares.
	1	Purchased used truck for NT$8,000, paying NT$2,000 cash and the balance on account.
	3	Purchased cleaning supplies for NT$900 on account.
	5	Paid NT$1,800 cash on a 1-year insurance policy effective July 1.
	12	Billed customers NT$3,700 for cleaning services performed.
	18	Paid NT$1,000 cash on amount owed on truck and NT$500 on amount owed on cleaning supplies.
	20	Paid NT$2,000 cash for employee salaries.
	21	Collected NT$1,600 cash from customers billed on July 12.
	25	Billed customers NT$2,500 for cleaning services performed.
	31	Paid NT$290 for maintenance of the truck during month.
	31	Declared and paid a NT$600 cash dividend.

The chart of accounts for Kleene Window Washing contains the following accounts: Cash, Accounts Receivable, Supplies, Prepaid Insurance, Equipment, Accumulated Depreciation—Equipment, Accounts Payable, Salaries and Wages Payable, Share Capital—Ordinary, Retained Earnings, Dividends, Income Summary, Service Revenue, Maintenance and Repairs Expense, Supplies Expense, Depreciation Expense, Insurance Expense, and Salaries and Wages Expense.

Instructions

a. Journalize the July transactions.

b. Post to the ledger accounts. (Use T-accounts.)

c. Prepare a trial balance at July 31.

d. Journalize the following adjustments.

1. Services performed but unbilled and uncollected at July 31 were NT$1,700.
2. Depreciation on equipment for the month was NT$180.
3. One-twelfth of the insurance expired.
4. A count shows NT$320 of cleaning supplies on hand at July 31.
5. Accrued but unpaid employee salaries were NT$400.

e. Post adjusting entries to the T-accounts.

f. Prepare an adjusted trial balance.

f. Cash NT$5,410

g. Prepare the income statement and a retained earnings statement for July and a classified statement of financial position at July 31.

g. Tot. assets NT$21,500

h. Journalize and post closing entries and complete the closing process.

i. Prepare a post-closing trial balance at July 31.

Complete all steps in accounting cycle.

ACR4.2 Lars Linken opened Lars Cleaners on March 1, 2025. During March, the following transactions were completed.

Mar.	1	Shareholders invested €15,000 cash in the business in exchange for ordinary shares.
	1	Borrowed €6,000 cash by signing a 6-month, 6%, €6,000 note payable. Interest will be paid the first day of each subsequent month.
	1	Purchased used truck for €8,000 cash.
	2	Paid €1,500 cash to cover rent from March 1 through May 31.
	3	Paid €2,400 cash on a 6-month insurance policy effective March 1.
	6	Purchased cleaning supplies for €2,000 on account.
	14	Billed customers €3,700 for cleaning services performed.
	18	Paid €500 on amount owed on cleaning supplies.
	20	Paid €1,750 cash for employee salaries.
	21	Collected €1,600 cash from customers billed on March 14.
	28	Billed customers €4,200 for cleaning services performed.
	31	Paid €350 for gas and oil used in truck during month (use Maintenance and Repairs Expense).
	31	Declared and paid a €900 cash dividend.

The chart of accounts for Lars Cleaners contains the following accounts: Cash, Accounts Receivable, Supplies, Prepaid Insurance, Prepaid Rent, Equipment, Accumulated Depreciation—Equipment, Accounts Payable, Salaries and Wages Payable, Notes Payable, Interest Payable, Share Capital—Ordinary, Retained Earnings, Dividends, Income Summary, Service Revenue, Maintenance and Repairs Expense, Supplies Expense, Depreciation Expense, Insurance Expense, Salaries and Wages Expense, Rent Expense, and Interest Expense.

Instructions

a. Journalize the March transactions.

b. Post to the ledger accounts. (Use T-accounts.)

c. Prepare a trial balance at March 31.

d. Journalize the following adjustments.

1. Services performed but unbilled and uncollected at March 31 were €200.
2. Depreciation on equipment for the month was €250.
3. One-sixth of the insurance expired.
4. An inventory count shows €280 of cleaning supplies on hand at March 31.
5. Accrued but unpaid employee salaries were €1,080.

6. One month of the prepaid rent has expired.
7. One month of interest expense related to the note payable has accrued and will be paid April 1. (*Hint:* Use the formula from Illustration 3.18 to compute interest.)

e. Post adjusting entries to the T-accounts.

f. Prepare an adjusted trial balance.

f. Tot. adj. trial balance €31,960

g. Prepare the income statement and a retained earnings statement for March and a classified statement of financial position at March 31.

g. Tot. assets €24,730

h. Journalize and post closing entries and complete the closing process.

i. Prepare a post-closing trial balance at March 31.

Journalize transactions and follow through accounting cycle to preparation of financial statements.

ACR4.3 On August 1, 2025, the following were the account balances of B&B Repair Services.

	Debit		Credit
Cash	$ 6,040	Accumulated Depreciation—Equipment	$ 600
Accounts Receivable	2,910	Accounts Payable	2,300
Notes Receivable	4,000	Unearned Service Revenue	1,260
Supplies	1,030	Salaries and Wages Payable	1,420
Equipment	10,000	Share Capital—Ordinary	16,300
		Retained Earnings	2,100
	$23,980		$23,980

During August, the following summary transactions were completed.

Aug.	1	Paid $400 cash for advertising in local newspapers. Advertising flyers will be included with newspapers delivered during August and September.
	3	Paid August rent $380.
	5	Received $1,200 cash from customers in payment on account.
	10	Paid $3,120 for salaries due employees, of which $1,700 is for August and $1,420 is for July salaries payable.
	12	Received $2,800 cash for services performed in August.
	15	Purchased store equipment on account $2,000.
	20	Paid creditors $2,000 of accounts payable due.
	22	Purchased supplies on account $800.
	25	Paid $2,900 cash for employees' salaries.
	27	Billed customers $3,760 for services performed.
	29	Received $780 from customers for services to be performed in the future.

Adjustment data:

1. A count shows supplies on hand of $960.
2. Accrued but unpaid employees' salaries are $1,540.
3. Depreciation on equipment for the month is $320.
4. Services were performed to satisfy $800 of unearned service revenue.
5. One month's worth of advertising services has been received.
6. One month of interest revenue related to the $4,000 note receivable has accrued. The 4-month note has a 6% annual interest rate. (*Hint:* Use the formula from Illustration 3.18 to compute interest.)

Instructions

a. Enter the August 1 balances in the ledger accounts. (Use T-accounts.)

b. Journalize the August transactions.

c. Post to the ledger accounts. B&B's chart of accounts includes Prepaid Advertising, Interest Receivable, Service Revenue, Interest Revenue, Advertising Expense, Depreciation Expense, Supplies Expense, Salaries and Wages Expense, and Rent Expense.

d. Prepare a trial balance at August 31.

e. Journalize and post adjusting entries.

f. Prepare an adjusted trial balance.

f. Cash $2,020Tot. adj. trial balance $32,580

g. Prepare an income statement and a retained earnings statement for August and a classified statement of financial position at August 31.

g. Net loss $530

h. Journalize and post closing entries and complete the closing process.

i. Prepare a post-closing trial balance at August 31.

Record and post transaction, adjusting, and closing journal entries; prepare adjusted trial balance and financial statements.

ACR4.4 At June 30, 2025, the end of its most recent fiscal year, Green River Computer Consultants' post-closing trial balance was as follows (amounts in thousands):

	Debit	Credit
Cash	¥5,230	
Accounts receivable	1,200	
Supplies	690	
Accounts payable		¥ 400
Unearned service revenue		1,120
Share capital—ordinary		4,000
Retained earnings		1,600
	¥7,120	¥7,120

The company underwent a major expansion in July. New staff was hired and more financing was obtained. Green River conducted the following transactions during July 2025, and adjusts its accounts monthly.

July	1	Purchased equipment, paying ¥4,000 cash and signing a 2-year note payable for ¥20,000. The equipment has a 4-year useful life. The note has a 6% interest rate which is payable on the first day of each following month.
	2	Shareholders invested ¥50,000 cash in the company in exchange for ordinary shares.
	3	Paid ¥3,600 cash for a 12-month insurance policy effective July 1.
	3	Paid the first 2 (July and August 2025) months' rent for an annual lease of office space for ¥4,000 per month.
	6	Paid ¥3,800 for supplies.
	9	Visited client offices and agreed on the terms of a consulting project. Green River will bill the client, Connor Productions, on the 20th of each month for services performed.
	10	Collected ¥1,200 cash on account from Milani Brothers. This client was billed in June when Green River performed the service.
	13	Performed services for Fitzgerald Enterprises. This client paid ¥1,120 in advance last month. All services relating to this payment are now completed.
	14	Paid ¥400 cash for a utility bill. This related to June utilities that were accrued at the end of June.
	16	Met with a new client, Thunder Bay Technologies. Received ¥12,000 cash in advance for future services to be performed.
	18	Paid semi-monthly salaries for ¥11,000.
	20	Performed services worth ¥28,000 on account and billed customers.
	20	Received a bill for ¥2,200 for advertising services received during July. The amount is not due until August 15.
	23	Performed the first phase of the project for Thunder Bay Technologies. Recognized ¥10,000 of revenue from the cash advance received July 16.
	27	Received ¥15,000 cash from customers billed on July 20.

Adjustment data:

1. Adjustment of prepaid insurance.
2. Adjustment of prepaid rent.
3. Supplies used, ¥1,250.
4. Equipment depreciation, ¥500 per month.
5. Accrual of interest on note payable. (*Hint:* Use the formula from Illustration 3.18 to compute interest.)
6. Salaries for the second half of July, ¥11,000, to be paid on August 1.
7. Estimated utilities expense for July, ¥800.
8. Income tax for July, ¥1,200, will be paid in August. (*Hint:* Use the accounts Income Tax Expense and Income Taxes Payable.)

The chart of accounts for Green River Computer Consultants contains the following accounts: Cash, Accounts Receivable, Supplies, Prepaid Insurance. Prepaid Rent, Equipment, Accumulated Depreciation—Equipment, Accounts Payable, Notes Payable, Interest Payable, Income Taxes Payable, Salaries and Wages Payable, Unearned Service Revenue, Share Capital—Ordinary, Retained Earnings, Income Summary, Service Revenue, Supplies Expense, Depreciation Expense, Insurance Expense, Salaries and Wages Expense, Advertising Expense, Income Tax Expense, Interest Expense, Rent Expense, and Utilities Expense.

Instructions

a. Enter the July 1 balances in the ledger accounts. (Use T-accounts.)

b. Journalize the July transactions.

c. Post to the ledger accounts.

d. Prepare a trial balance at July 31.

e. Journalize and post adjusting entries for the month ending July 31.

f. Prepare an adjusted trial balance.

g. Prepare an income statement and a retained earnings statement for July and a classified statement of financial position at July 31.

g. Net income ¥6,770 Tot. assets ¥99,670

h. Journalize and post closing entries and complete the closing process.

i. Prepare a post-closing trial balance at July 31.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT4.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

a. Answer the questions below using the statement of financial position and the notes to consolidated financial statements section.

b. What were TSMC's total current assets at December 31, 2019, and December 31, 2020?

c. Are assets that TSMC included under current assets listed in proper order? Explain.

d. How are TSMC's assets classified?

e. What were TSMC's total current liabilities at December 31, 2019, and December 31, 2020?

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT4.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information contained in these financial statements, determine each of the following for Nestlé and Delfi at December 31, 2020.

1. Total current assets.
2. Net amount of property, plant, and equipment (land, buildings, and equipment).
3. Total current liabilities.
4. Total equity.

b. What conclusions concerning the companies' respective financial positions can be drawn from the companies' current assets and current liabilities?

Real-World Focus

CT4.3 Most companies have established home pages on the Internet, e.g., **Gitanjali Group** (IND) and **Wumart** (CHN).

Instructions

a. Examine the home pages of any two companies and answer the following questions.

b. What type of information is available?

c. Is any accounting-related information presented?

d. Would you describe the home page as informative, promotional, or both? Why?

Decision-Making Across the Organization

CT4.4 Whitegloves Janitorial Service was started 2 years ago by Jenna Olson. Because business has been exceptionally good, Jenna decided on July 1, 2025, to expand operations by acquiring an additional truck and hiring two more assistants. To finance the expansion, Jenna obtained on July 1, 2025, a £25,000, 10% bank loan, payable £10,000 on July 1, 2026, and the balance on July 1, 2027. The terms of the loan require the borrower to have £10,000 more current assets than current liabilities at December 31, 2025. If these terms are not met, the bank loan will be refinanced at 15% interest. At December 31, 2025, the accountant for Whitegloves Janitorial Service prepared the following statement of financial position.

Whitegloves Janitorial Service
Statement of Financial Position
December 31, 2025

Assets			Equity and Liabilities		
Property, plant, and equipment			Equity		
Equipment (net)	£22,000		Share capital—ordinary	£41,000	
Delivery trucks (net)	34,000	£56,000	Retained earnings	13,000	£54,000
Current assets			Non-current liabilities		
Prepaid insurance	4,800		Notes payable		15,000
Supplies	5,200		Current liabilities		
Accounts receivable	9,000		Notes payable	10,000	
Cash	5,500	24,500	Accounts payable	1,500	11,500
Total assets		£80,500	Total equity and liabilities		£80,500

Jenna presented the statement of financial position to the bank's loan officer on January 2, 2026, confident that the company had met the terms of the loan. The loan officer was not impressed. She said, "We need financial statements audited by a CA." A CA was hired and immediately realized that the statement of financial position had been prepared from a trial balance and not from an adjusted trial balance. The adjustment data at the statement of financial position date consisted of the following.

1. Unbilled janitorial services performed were £3,700.
2. Janitorial supplies on hand were £2,500.
3. Prepaid insurance was a 3-year policy dated January 1, 2025.
4. December expenses incurred but unpaid at December 31, £500.
5. Interest on the bank loan was not recorded.
6. The amounts for property, plant, and equipment presented in the statement of financial position were reported net of accumulated depreciation (cost less accumulated depreciation). These amounts were £4,000 for cleaning equipment and £5,000 for delivery trucks as of January 1, 2025. Depreciation for 2025, still unrecorded, was £2,000 for cleaning equipment and £5,000 for delivery trucks.

Instructions

With the class divided into groups, answer the following.

a. Prepare a correct statement of financial position.

b. Were the terms of the bank loan met? Explain.

Communication Activity

CT4.5 The accounting cycle is important in understanding the accounting process.

Instructions

Write an email to your instructor that lists the steps of the accounting cycle in the order they should be completed. End with a paragraph that explains the optional steps in the cycle.

Ethics Case

CT4.6 As the controller of Take No Prisoners Perfume, you discover a misstatement that overstated net income in the prior year's financial statements. The misleading financial statements appear in the company's annual report which was issued to banks and other creditors less than a month ago. After

much thought about the consequences of telling the president, Fabien LaRue, about this misstatement, you gather your courage to inform him. Fabien says, "Hey! What they don't know won't hurt them. But, just so we set the record straight, we'll adjust this year's financial statements for last year's misstatement. We can absorb that misstatement better in this year than in last year anyway! Just don't make such a mistake again."

Instructions

a. Who are the stakeholders in this situation?

b. What are the ethical issues in this situation?

c. What would you do as a controller in this situation?

All About You

CT4.7 Companies prepare statements of financial position in order to know their financial position at a specific point in time. This enables them to make a comparison to their position at previous points in time, and gives them a basis for planning for the future. In order to evaluate your financial position, you may need to prepare a personal statement of financial position. Assume that you have compiled the following information regarding your finances. (*Note:* Some of the items might not be used in your personal statement of financial position.)

Amount owed on student loan balance (long-term)	€ 5,000
Balance in checking account	1,200
Investment (short-term)	3,000
Annual earnings from part-time job	11,300
Automobile	7,000
Balance on automobile loan (current portion)	1,500
Balance on automobile loan (long-term portion)	4,000
Home computer	800
Amount owed to you by younger brother	300
Balance in savings account	1,800
Annual tuition	6,400
Video and stereo equipment	1,250
Balance owed on credit card (current portion)	1,800

Instructions

Prepare a personal statement of financial position using the format you have learned for a classified statement of financial position for a company. For the equity account, use Owner's Capital.

A Look at U.S. GAAP

LEARNING OBJECTIVE 6

Compare the procedures for the accounting cycle under IFRS and U.S. GAAP.

The classified statement of financial position, although generally required internationally, contains certain variations in format when reporting under GAAP.

Key Points

- In general, GAAP follows the similar guidelines as this text for presenting items in the current asset section, except that under GAAP items are listed in order of liquidity, while under IFRS they are often listed in reverse order of liquidity. For example, under GAAP cash is listed first, but under IFRS it is listed last.
- Both GAAP and IFRS are increasing the use of fair value to report assets. However, at this point IFRS has adopted it more broadly. As examples, under IFRS companies can apply fair value to property, plant, and equipment; natural resources; and in some cases intangible assets.

Similarities

- Both IFRS and GAAP require disclosures about (1) accounting policies followed, (2) judgments that management has made in the process of applying the entity's accounting policies, and (3) the key assumptions and estimation uncertainty that could result in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- Comparative prior-period information must be presented and financial statements must be prepared annually.

Differences

- IFRS requires that a company must make an explicit and unreserved statement that the financial statements comply with IFRS standards. No similar statement is required under GAAP.
- IFRS officially uses the term *statement of financial position* in its literature, while in the United States it is often referred to as the *balance sheet*.
- IFRS requires that specific items be reported on the statement of financial position, whereas no such general standard exists in GAAP. However, under GAAP, public companies must follow U.S. Securities and Exchange Commission (SEC) regulations, which require specific line items as well. In addition, specific GAAP standards mandate certain forms of reporting statement of financial position information. The SEC guidelines are more detailed than IFRS.
- IFRS requires that a complete set of financial statements must include comparative information from the preceding period. There is no similar requirement in GAAP. However, public companies following U.S. SEC regulations have a similar requirement.
- While IFRS companies often report non-current assets before current assets in their statements of financial position, this is never seen under GAAP. Also, some IFRS companies report the subtotal "net assets," which equals total assets minus total liabilities. This practice is also not seen under GAAP.
- A key difference in valuation is that under IFRS, companies, under certain conditions, can report property, plant, and equipment at cost or at fair value, whereas under GAAP this practice is not allowed.
- GAAP has many differences in terminology from what are shown in your text. For example, in the following sample balance sheet (statement of financial position), notice in the investment category that shares are called stock. In addition, the format used for statement of financial position presentation is often different between GAAP and IFRS.

Franklin Corporation
Balance Sheet
October 31, 2025

Assets

Current assets			
Cash		$ 6,600	
Short-term investments		2,000	
Accounts receivable		7,000	
Notes receivable		1,000	
Inventory		3,000	
Supplies		2,100	
Prepaid insurance		400	$22,100
Long-term investments			
Investment in stock of Walters Corp.		5,200	
Investment in real estate		2,000	7,200
Property, plant, and equipment			
Land		10,000	
Equipment	$24,000		
Less: Accumulated depreciation—equipment	5,000	19,000	29,000
Intangible assets			
Patents			3,100
Total assets			$61,400

Liabilities and Stockholders' Equity

Current liabilities			
Notes payable		$11,000	
Accounts payable		2,100	
Salaries and wages payable		1,600	
Unearned service revenue		900	
Interest payable		450	$16,050
Long-term liabilities			
Mortgage payable		10,000	
Notes payable		1,300	11,300
Stockholders' equity			
Common stock		20,000	
Retained earnings		14,050	34,050
Total liabilities and stockholders' equity			$61,400

GAAP Practice

GAAP Self-Test Questions

1. Which of the following statements is **false**?

a. Assets equals liabilities plus stockholders' equity.

b. Under IFRS, companies sometimes net liabilities against assets to report "net assets."

c. Both GAAP and IFRS are increasing the use of fair value to report assets.

d. Under GAAP, the statement of financial position is usually referred to as the statement of assets and equity.

Answer

2. A company has purchased a tract of land and expects to build a production plant on the land in approximately 5 years. During the 5 years before construction, the land will be idle. Under GAAP, the land should be reported as:

a. land expense.

b. property, plant, and equipment.

c. an intangible asset.

d. a long-term investment.

Answer

3. Current assets under GAAP are listed generally:

a. by importance.

b. in the reverse order of their expected conversion to cash.

c. by order of liquidity.

d. alphabetically.

Answer

4. Companies that use GAAP:

a. may report all their assets on their balance sheets at fair value.

b. often offset assets against liabilities and show net assets and net liabilities on their balance sheets, rather than the underlying detailed line items.

c. generally report current assets before non-current assets on their balance sheets.

d. do not have any guidelines as to what should be reported on their balance sheets.

Answer

5. Companies that follow GAAP to prepare a balance sheet generally use the following order of classification:

a. current assets, long-term assets, current liabilities, long-term liabilities, stockholders' equity.

b. long-term assets, long-term liabilities, current assets, current liabilities, stockholders' equity.

c. long-term assets, current assets, stockholders' equity, long-term liabilities, current liabilities.

d. stockholders' equity, long-term assets, current assets, long-term liabilities, current liabilities.

Answer

GAAP Exercises

GAAP4.1 In what ways does the format of a statement of financial of position under IFRS often differ from a balance sheet presented under GAAP?

GAAP4.2 What term is commonly used under GAAP in reference to the statement of financial position?

GAAP4.3 The balance sheet for Diaz Company includes the following accounts: Accounts Receivable $12,500; Prepaid Insurance $3,600; Cash $15,400; Supplies $5,200; and Short-Term Investments $6,700. Prepare the current assets section of the balance sheet, listing the accounts in proper sequence using GAAP.

GAAP4.4 Zurich Company recently received the following information related to the company's December 31, 2025, balance sheet.

Inventories	$ 2,700	Short-term investments	$ 120
Cash	13,100	Accumulated depreciation—equipment	5,700
Equipment	21,700		
Investments in stocks (long-term)	6,500	Accounts receivable	4,300

Prepare the assets section of the company's classified balance sheet using GAAP.

GAAP4.5 The following information is available for Rego Bowling Alley at December 31, 2025, its first year of operation.

Buildings	$128,000	Interest Expense	$ 2,600
Accounts Receivable	7,540	Common Stock	112,000
Prepaid Insurance	4,680	Accumulated Depreciation—Buildings	42,600
Cash	18,040	Accounts Payable	12,300
Equipment	62,400	Notes Payable	95,000
Land	67,000	Accumulated Depreciation—Equipment	18,720
Insurance Expense	780	Interest Payable	2,600
Depreciation Expense	7,360	Service Revenue	15,180

Prepare a classified balance sheet using GAAP; assume that $13,900 of the notes payable will be paid in 2026.

GAAP4.6 Brian Hopkins is interested in comparing the liquidity and solvency of a U.S. software company with a Chinese competitor. Is this possible if the two companies report using different currencies?

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP4.7 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

a. What were Apple's total current assets at September 26, 2020, and September 28, 2019?

b. Are the assets included in current assets listed in the proper order? Explain.

c. How are Apple's assets classified?

d. What were Apple's current liabilities at September 26, 2020, and September 28, 2019?

CHAPTER 5
Accounting for Merchandise Operations



HBSS/Corbis/Getty Images

Chapter Preview

Merchandising is one of the largest and most influential industries in the world. It is likely that a number of you will work for a merchandiser. Therefore, understanding the financial statements of merchandising companies is important. In this chapter, you will learn the basics about reporting merchandising transactions. In addition, you will learn how to prepare and analyze a commonly used form of the income statement.

Feature Story

Who Doesn't Shop?

Carrefour, headquartered in France, is the largest retailer in Europe and the second largest retailer in the world. While 40% of its sales are in France, it operates stores under a variety of names in 32 countries in Europe, Asia, and Latin America, such as Carrefour Express, Dity, Ed, Minipreco, and Promocash. Its nearly 10,000 stores employ 471,000 people and generate sales of €112 billion.

Becoming an international titan hasn't always been easy. Carrefour has enjoyed some successful mergers and acquisitions. But, it has also experienced setbacks, including a failed effort to acquire a giant Brazilian retailer. It has had some success in increasing market share in emerging markets. But, by far the largest share of its sales are in Europe, which has experienced low consumer confidence in recent years due to the recession and debt crisis. As a result, Carrefour's increases in emerging markets have only served to offset declines in Europe.

Management has experienced upheaval, with three new chief executive officers during a seven-year period. Investors in recent years have withdrawn support for the company, resulting in a drop in Carrefour's share price of two-thirds in less than five years. At times, the company has struggled strategically. Recently, it decided to quit using temporary price cuts to promote products. Instead, Carrefour sets prices low on certain key items. It also decided to not set its prices as low as those of bargain stores, such as **E.Leclerc** (FRA). Carrefour's management felt that the additional services the company provides would enable it to charge slightly higher prices than bargain stores without losing customers. However, poor economic conditions made consumers extremely price-conscious. As a result, the company has seen a significant drop in customer traffic.

Nobody said retailing is easy, but at number two in the world, Carrefour has no intention of throwing in the towel. The company recently launched a makeover of 500 superstores in Europe, and it continues to look for expansion

opportunities in countries that have good growth opportunities. Recently, the company opened its first store in India. Lars Olofsson, CEO of Carrefour, declared: "The opening of this first store marks Carrefour's entry into the Indian market and will be followed shortly by the opening of other Cash & Carry stores. This first step is essential to allow the Carrefour teams to fully understand the specificities of the Indian market and then build our presence in other formats."

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Describe merchandising operations and inventory systems.	• Operating cycles • Flow of costs	DO IT! 1 Merchandising Operations and Inventory Systems
LO 2 Record purchases under a perpetual inventory system.	• Freight costs • Purchase returns and allowances • Purchase discounts • Summary of purchasing transactions	DO IT! 2 Purchase Transactions
LO 3 Record sales under a perpetual inventory system.	• Sales returns and allowances • Sales discounts • Data analytics and credit sales	DO IT! 3 Sales Transactions
LO 4 Apply the steps in the accounting cycle to a merchandising company.	• Adjusting entries • Closing entries • Summary of merchandising entries	DO IT! 4 Closing Entries
LO 5 Prepare financial statements for a merchandising company.	• Income statement • Classified statement of financial position	DO IT! 5 Financial Statement Classifications

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

5.1 Merchandising Operations and Inventory Systems

LEARNING OBJECTIVE 1

Describe merchandising operations and inventory systems.

Metro (DEU), **Carrefour** (FRA), and **Tesco** (GBR) are called merchandising companies because they buy and sell merchandise rather than perform services as their primary source of revenue.

- Merchandising companies that purchase and sell directly to consumers are called **retailers**.
- Merchandising companies that sell to retailers are known as **wholesalers**.

For example, retailer **Walgreens** (USA) might buy goods from wholesaler **Grupo Casa SA de CV** (MEX). Retailer **Office Depot** (USA) might buy office supplies from wholesaler **Corporate Express** (NLD).

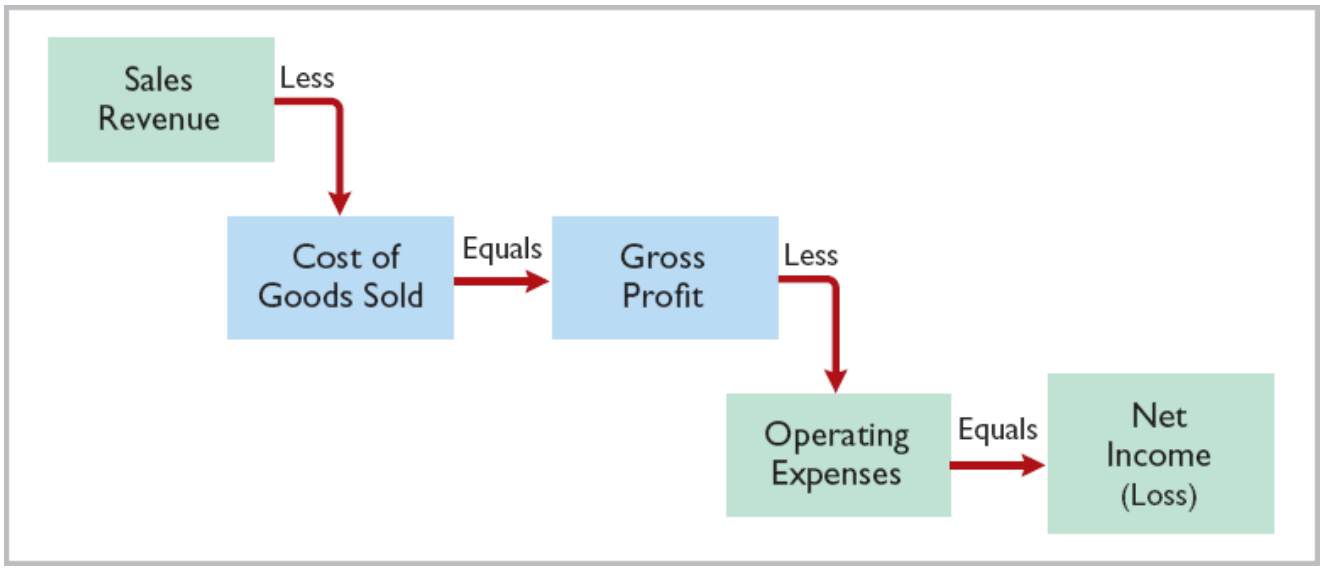
The primary source of revenue for merchandising companies is the sale of merchandise, often referred to simply as **sales revenue** or **sales**. A merchandising company has two categories of expenses: cost of goods sold and operating expenses.

1. **Cost of goods sold** is the total cost of merchandise sold during the period. This expense is directly related to the revenue recognized from the sale of goods.

2. **Operating expenses** are incurred in the process of earning sales revenue. Examples include advertising expense and rent expense. Note that operating expenses are a category of expenses, not a single line item on the income statement.

Illustration 5.1 shows the income measurement process for a merchandising company. The items in the two blue boxes are unique to a merchandising company; they are not used by a service company.

ILLUSTRATION 5.1 Income measurement process for a merchandising company



Operating Cycles

The operating cycle of a merchandising company ordinarily is longer than that of a service company. The purchase of merchandise inventory and its eventual sale lengthen the cycle. Illustration 5.2 shows the operating cycle of a service company.

ILLUSTRATION 5.2 Operating cycle for a service company

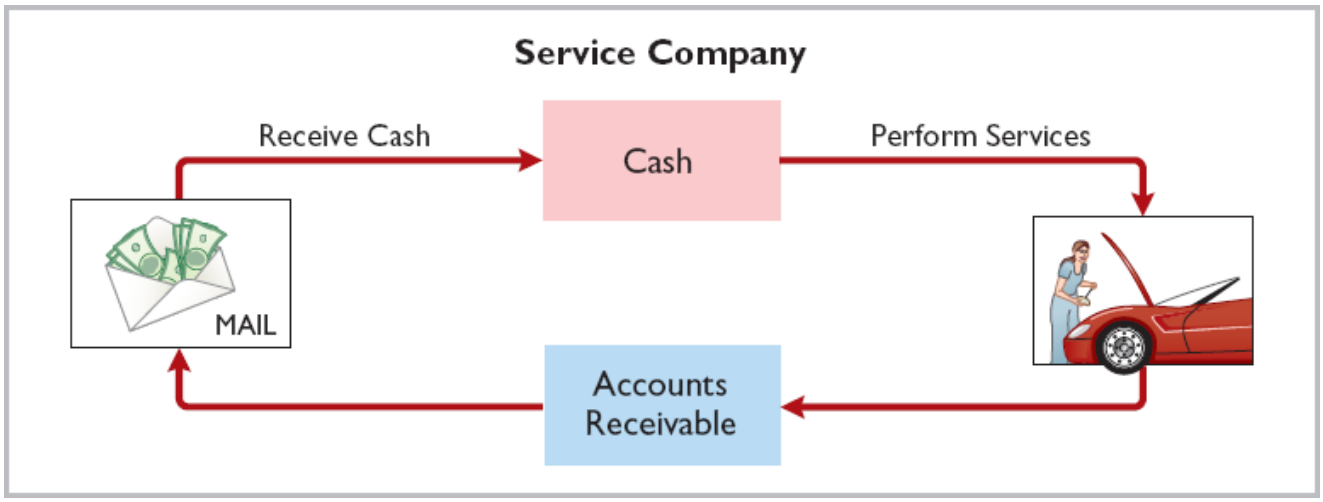
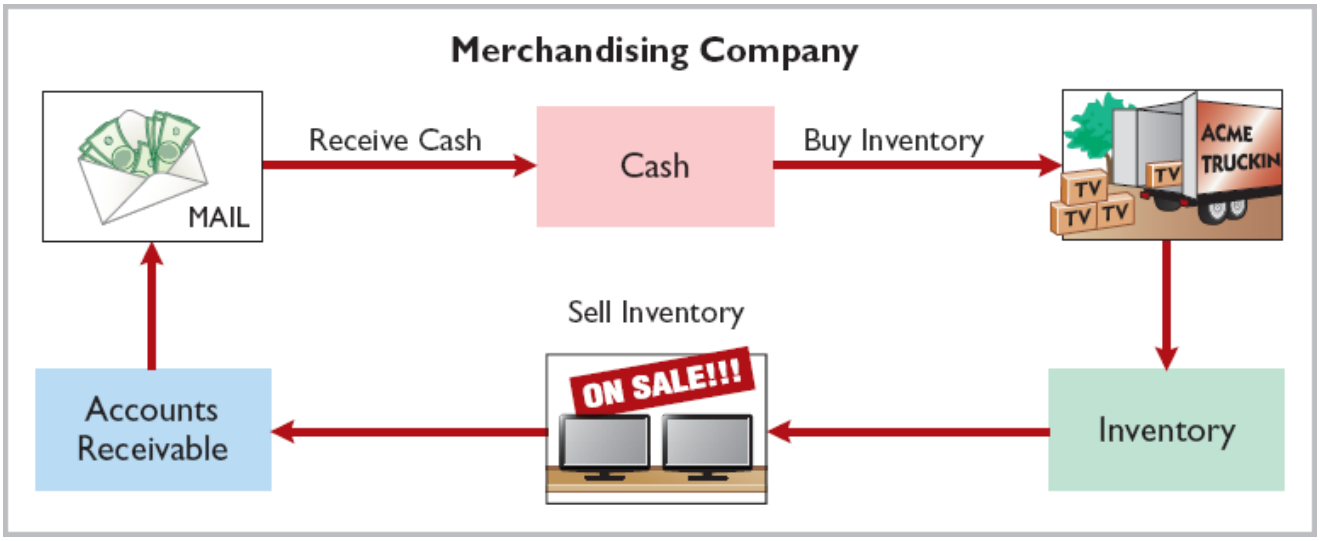


Illustration 5.3 shows the operating cycle of a merchandising company.

ILLUSTRATION 5.3 **Operating cycle for a merchandising company**



Note that the added asset account for a merchandising company is the Inventory account. Companies report inventory as a current asset on the statement of financial position.

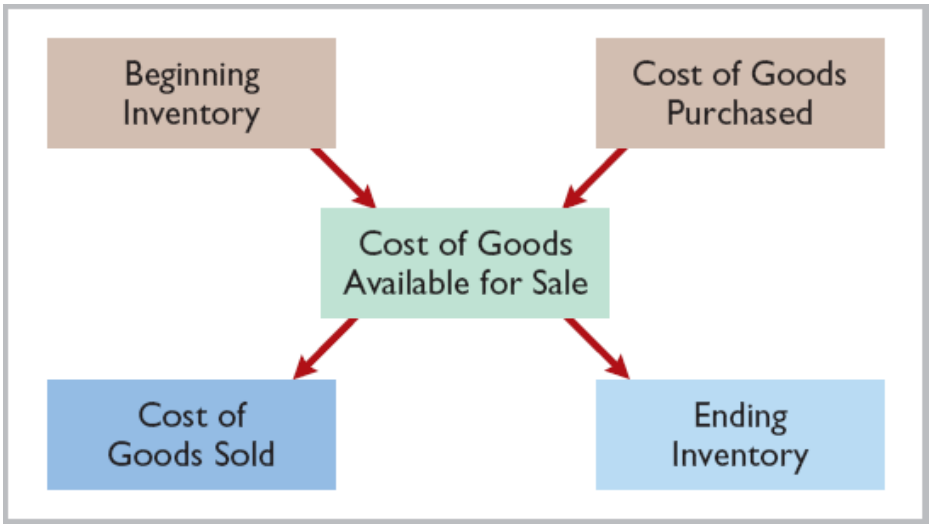
Flow of Costs

The flow of costs for a merchandising company is as follows.

- Beginning inventory plus the cost of goods purchased is the cost of goods available for sale.
- As goods are sold, they are assigned to cost of goods sold.
- Those goods that are not sold by the end of the accounting period represent ending inventory.

Illustration 5.4 describes these relationships.

ILLUSTRATION 5.4 **Flow of costs**



Companies use one of two systems to account for inventory: a **perpetual inventory system** or a **periodic inventory system**.

Perpetual System

In a perpetual inventory system, companies keep detailed records of the cost of each inventory purchase and sale (see Helpful Hint). These records continuously—perpetually—show the inventory that should be on hand for every item. For example, a **Toyota** (JPN) dealership has separate inventory records for each automobile, truck, and van on its lot and showroom floor. Similarly, a **Morrisons** (GBR) grocery store uses bar codes and optical scanners to keep a daily running record of every box of cereal and every jar of jelly that it buys and sells. Under a perpetual inventory system, a company determines the cost of goods sold **each time a sale occurs**.

> **HELPFUL HINT**
>
> **Even under perpetual inventory systems, companies take a physical inventory count. This is done as a control procedure to verify inventory levels, in order to detect theft or "shrinkage."**

Periodic System

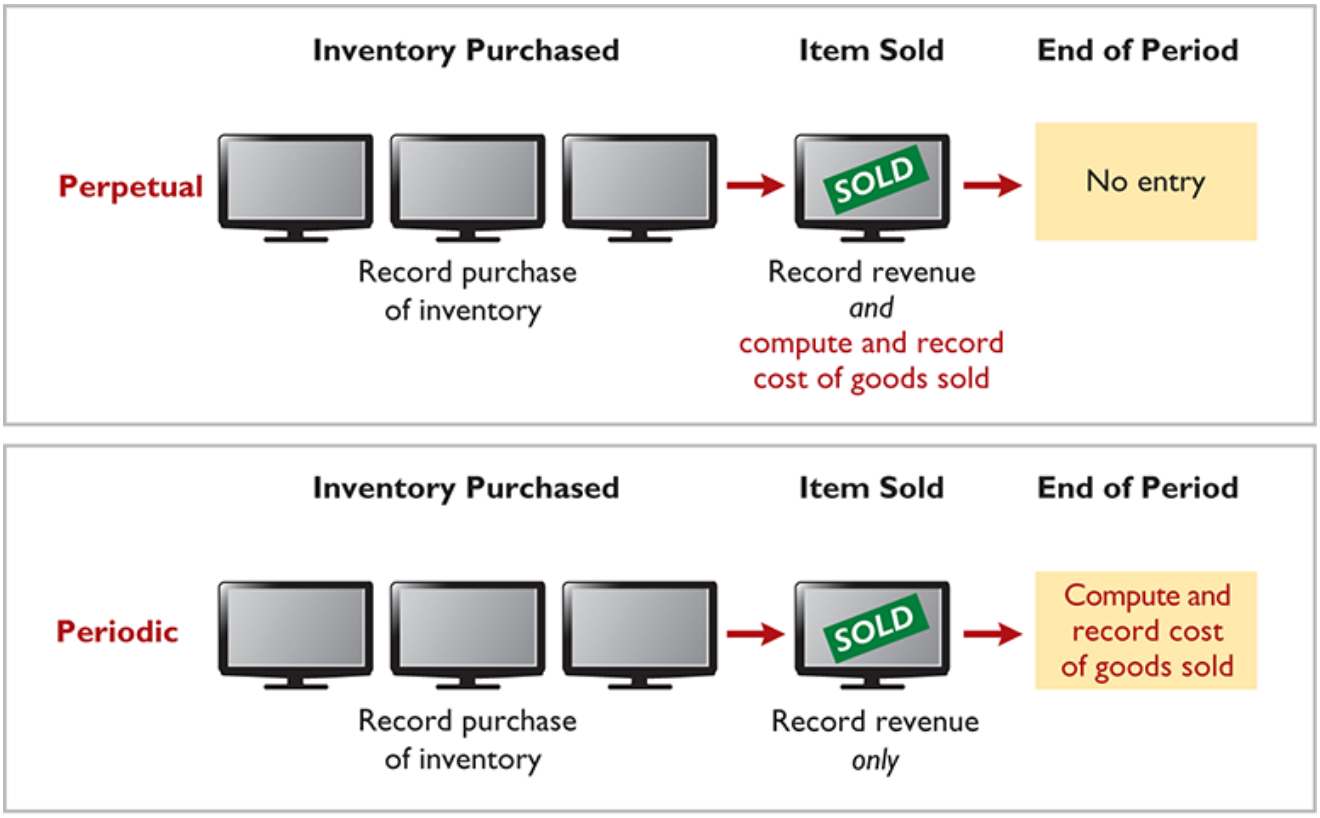
In a **periodic inventory system**, companies do not keep detailed inventory records of the goods on hand throughout the period. Instead, they determine the cost of goods sold **only at the end of the accounting period**—that is, periodically. At that point, the company takes a physical inventory count to determine the cost of goods on hand.

To determine the cost of goods sold under a periodic inventory system, the following steps are necessary.

1. Determine the cost of goods on hand at the beginning of the accounting period.
2. Add to it the cost of goods purchased.
3. Subtract the cost of goods on hand as determined by the physical inventory count at the end of the accounting period.

Illustration 5.5 compares the sequence of activities and the timing of the cost of goods sold computation under the two inventory systems.

ILLUSTRATION 5.5 Comparing perpetual and periodic inventory systems



Advantages of the Perpetual System

Companies that sell merchandise with high unit values, such as automobiles, furniture, and major home appliances, have traditionally used perpetual systems. The growing use of computers and electronic scanners has enabled many more companies to install perpetual inventory systems. The perpetual inventory system is so named because the accounting records continuously—perpetually—show the quantity and cost of the inventory that should be on hand at any time.

A perpetual inventory system provides better control over inventories than a periodic system.

- Since the inventory records show the quantities that should be on hand, the company can count the goods at any time to see whether the amount of goods actually on hand agrees with the inventory records.
- If shortages are uncovered, the company can investigate immediately.

Although a perpetual inventory system requires both additional clerical work and expense to maintain the subsidiary records, a computerized system can minimize this cost. Much of **Amazon.com**'s (USA) success is attributed to its sophisticated inventory system.

Some businesses find it either unnecessary or uneconomical to invest in a computerized perpetual inventory system. Many small merchandising businesses now use basic accounting software, which provides some of the essential benefits of a perpetual inventory system. Also, managers of some small businesses still find that they can control their merchandise and manage day-to-day operations using a periodic inventory system.

Because of the widespread use of the perpetual inventory system, we illustrate it in this chapter. We discuss and illustrate the periodic system in Appendix 5B.

Investor Insight

Improving Its Share Appeal



Sportstock/Getty Images

Investors are often eager to invest in a company that has a hot new product. However, when a fast-growing snowboard-maker issued ordinary shares to the public for the first time, some investors expressed reluctance to invest in it because of a number of accounting control problems.

To reduce investor concerns, the company implemented a perpetual inventory system to improve its control over inventory. In addition, the company stated that it would perform a physical inventory count every quarter until it felt that its perpetual inventory system was reliable.

If a perpetual system keeps track of inventory on a daily basis, why do companies ever need to do a physical count?

Answer

DO IT! 1

Merchandising Operations and Inventory Systems

Indicate whether the following statements are true or false. If false, indicate how to correct the statement.

1. The primary source of revenue for a merchandising company results from performing services for customers.
2. The operating cycle of a service company is usually shorter than that of a merchandising company.
3. Sales revenue less cost of goods sold equals gross profit.
4. Ending inventory plus the cost of goods purchased equals cost of goods available for sale.

ACTION PLAN

- **Review merchandising concepts.**
- **Understand the flow of costs in a merchandising company.**

Solution

Related exercise material: **BE5.1**, **DO IT! 5.1**, **and** **E5.1**.

5.2 Recording Purchases Under a Perpetual System

LEARNING OBJECTIVE 2

Record purchases under a perpetual inventory system.

Companies purchase inventory using cash or credit (on account). They normally record purchases when they receive the goods from the seller. Every purchase should be supported by business documents that provide written evidence of the transaction. Each cash purchase should be supported by a canceled check or a cash register receipt indicating the items purchased and amounts paid. Companies record cash purchases by an increase in Inventory and a decrease in Cash.

- A **purchase invoice** should support each credit purchase.
- This invoice indicates the total purchase price and other relevant information.

However, the purchaser does not prepare a separate purchase invoice. Instead, the purchaser uses as a purchase invoice a copy of the sales invoice sent by the seller. In Illustration 5.6, for example, Sauk Stereo (the buyer) uses as a purchase invoice the sales invoice prepared by PW Audio Supply (the seller) (see Helpful Hint).

HELPFUL HINT

To better understand the contents of this invoice, identify these items:

1. **Seller**
2. **Invoice date**
3. **Purchaser**
4. **Salesperson**
5. **Credit terms**
6. **Freight terms**
7. **Goods sold: catalog number, description, quantity, price per unit**
8. **Total invoice amount**

ILLUSTRATION 5.6 Sales invoice used as purchase invoice by Sauk Stereo

INVOICE NO. 731

PW AUDIO SUPPLY
27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

SOLD TO
Firm Name Sauk Stereo
Attention of James Hoover, Purchasing Agent
Address 125 Main Street
Oslo Norway 283

Date 5/4/25	Salesperson Malone	Terms 2/10, n/30	FOB Shipping Point	
Catalog No.	Description	Quantity	Price	Amount
X572Y9820	Printed Circuit Board-prototype	1	2,300	€2,300
A2547Z45	Production Model Circuits	5	300	1,500
IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS			TOTAL	€3,800

Sauk Stereo makes the following journal entry to record its purchase from PW Audio Supply an account. The entry increases (debits) Inventory and increases (credits) Accounts Payable.

May 4	Inventory	3,800	
	Accounts Payable		3,800
	(To record goods purchased on account from PW Audio Supply)		

A	=	L	+	E
+3,800				
		+3,800		

Cash Flows
no effect

Under the perpetual inventory system, companies record purchases of merchandise for sale in the Inventory account. Thus, **Carrefour** would increase (debit) Inventory for clothing, sporting goods, and anything else purchased for resale to customers.

Not all purchases are debited to Inventory, however. Companies record purchases of assets acquired for use and not for resale, such as supplies, equipment, and similar items, as increases to specific asset accounts rather than to Inventory. For example, to record the purchase of materials used to make shelf signs or for cash register receipt paper, Carrefour would increase (debit) Supplies.

Freight Costs

Freight terms are agreed to by the buyer and seller. They indicate who is responsible for paying the freight charges (shipping costs) and who is responsible for the risk of loss or damage to the merchandise during transport. Identifying which party bears the risk of loss or damage is an important factor in determining when the goods cease being an asset of the seller and become an asset of the buyer.

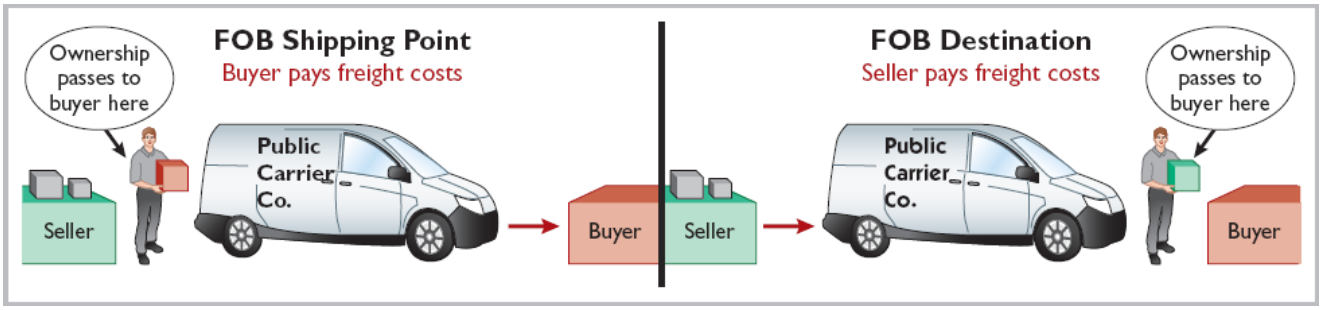
Freight terms are expressed as either FOB shipping point or FOB destination. The letters FOB mean **free on board** until the point where ownership is transferred.

- **FOB shipping point** means that ownership of goods passes to the buyer when the public carrier accepts the goods from the seller. The buyer is responsible for the freight costs from the shipping point to the buyer's destination (normally the buyer's place of business). The buyer is also responsible for any loss or damage that occurs along the way. In other words, the goods become part of the buyer's inventory at the point of shipping even though the goods will not arrive at the buyer's destination for several days or even weeks.
- **FOB destination** means that ownership of goods remains with the seller until the goods reach the buyer. The seller is responsible for delivering the goods to the destination. The seller pays the freight costs for transporting the goods to the buyer's destination and is responsible for any loss or damage that occurs along the way. As such, the goods would be included in the seller's inventory until they are delivered.

For example, the sales invoice in Illustration 5.6 indicates FOB shipping point. (see **Helpful Hint**). Thus, the buyer (Sauk Stereo) pays the freight charges. **Illustration 5.7** shows these shipping terms.

> **HELPFUL HINT**
> **The buyer pays freight only when the shipping terms are FOB shipping point.**

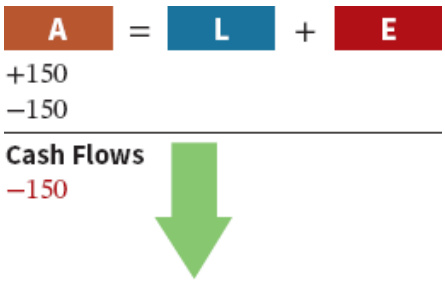
ILLUSTRATION 5.7 Shipping terms



Freight Costs Incurred by the Buyer

When the buyer incurs the transportation costs, these costs are considered part of the cost of purchasing inventory. Therefore, the buyer debits (increases) the Inventory account. For example, if Sauk Stereo (the buyer) pays Acme Freight €150 for freight charges on May 6, the entry on Sauk Stereo's books is:

May 6	Inventory	150	
	Cash		150
	(To record payment of freight on goods purchased)		

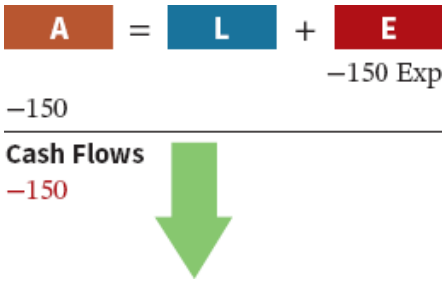


Thus, any freight costs incurred by the buyer are part of the cost of merchandise purchased. The reason: Inventory cost should include all costs to acquire the inventory, including freight necessary to deliver the goods to the buyer. Companies recognize these costs as cost of goods sold when the inventory is sold.

Freight Costs Incurred by the Seller

In contrast, **freight costs incurred by the seller on outgoing merchandise are an operating expense to the seller**. These costs increase an expense account titled Freight-Out (sometimes called Delivery Expense). For example, if the freight terms on the invoice in Illustration 5.6 had required PW Audio Supply (the seller) to pay the freight charges, the entry by PW Audio Supply would be:

May 4	Freight-Out (or Delivery Expense)	150	
	Cash		150
	(To record payment of freight on goods sold)		



When the seller pays the freight charges, the seller will usually establish a higher invoice price for the goods to cover the shipping expense.

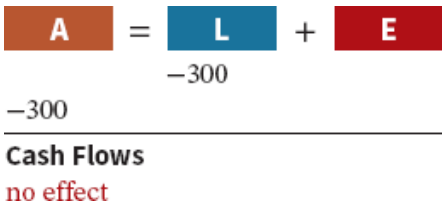
Purchase Returns and Allowances

A purchaser may be dissatisfied with the merchandise received because the goods are damaged or defective, of inferior quality, or do not meet the purchaser's specifications.

- The purchaser may return the goods to the seller for credit if the sale was made on credit, or for a cash refund if the purchase was for cash. This transaction is known as a **purchase return**.
- Or, the purchaser may choose to keep the merchandise if the seller is willing to grant an allowance (deduction) from the purchase price. This transaction is known as a **purchase allowance**.

Assume that Sauk Stereo returned goods costing €300 to PW Audio Supply on May 8. The following entry by Sauk Stereo for the returned merchandise decreases (debits) Accounts Payable and decreases (credits) Inventory.

May 8	Accounts Payable	300	
	Inventory		300
	(To record return of goods purchased from PW Audio Supply)		



Because Sauk Stereo increased Inventory when the goods were received, Inventory is decreased when Sauk Stereo returns the goods (or when it is granted an allowance).

Suppose instead that Sauk Stereo chose to keep the goods after being granted a €50 allowance (reduction in price). It would reduce (debit) Accounts Payable and reduce (credit) Inventory for €50.

Purchase Discounts

The credit terms of a purchase on account may permit the buyer to claim a cash discount for prompt payment.

- The buyer calls this cash discount a **purchase discount**.
- This incentive offers advantages to both parties: The purchaser saves money, and the seller is able to shorten the operating cycle by converting the accounts receivable into cash.

Credit terms specify the amount of the cash discount and time period in which it is offered. They also indicate the time period in which the purchaser is expected to pay the full invoice price.

- In the sales invoice in Illustration 5.6 credit terms are 2/10, n/30, which is read "two-ten, net thirty" (see **Helpful Hint**).
- This means that the buyer may take a 2% cash discount on the invoice price less ("net of") any returns or allowances, if payment is made within 10 days of the invoice date (the **discount period**).
- Otherwise, the invoice price, less any returns or allowances, is due 30 days from the invoice date.

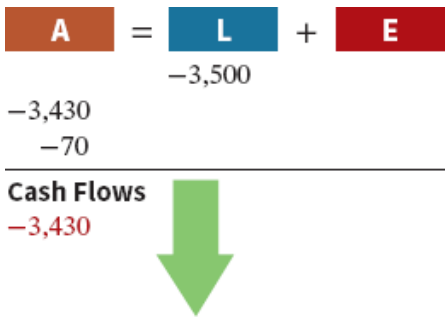
> **HELPFUL HINT**
>
> **The term *net* in "net 30" means the remaining amount due after subtracting any purchase returns and allowances and partial payments.**

Alternatively, the discount period may extend to a specified number of days following the month in which the sale occurs. For example, 1/10 EOM (end of month) means that a 1% discount is available if the invoice is paid within the first 10 days of the next month.

When the seller elects not to offer a cash discount for prompt payment, credit terms will specify only the maximum time period for paying the balance due. For example, the invoice may state the time period as n/30, n/60, or n/10 EOM. This means, respectively, that the buyer must pay the net amount in 30 days, 60 days, or within the first 10 days of the next month.

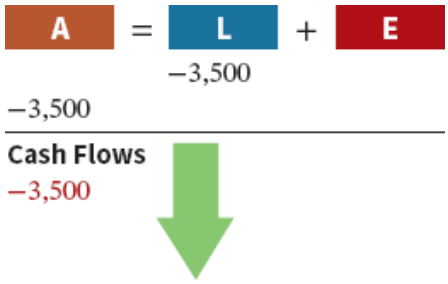
When the buyer pays an invoice within the discount period, the amount of the discount decreases Inventory. Why? Because companies record inventory at cost, and by paying within the discount period, the buyer has reduced its cost. To illustrate, assume Sauk Stereo pays the balance due of €3,500 (gross invoice price of €3,800 less purchase returns and allowances of €300) on May 14, the last day of the discount period. Since the terms are 2/10, n/30, the cash discount is €70 (€3,500 × 2%), and Sauk Stereo pays €3,430 (€3,500 − €70). The entry Sauk Stereo makes to record its May 14 payment decreases (debits) Accounts Payable by the amount of the gross invoice price, reduces (credits) Inventory by the €70 discount, and reduces (credits) Cash by the net amount owed.

May 14	Accounts Payable	3,500	
	Cash		3,430
	Inventory		70
	(To record payment within discount period)		



If Sauk Stereo failed to take the discount and instead made full payment of €3,500 on June 3, it would debit Accounts Payable and credit Cash for €3,500 each.

June 3	Accounts Payable	3,500	
	Cash		3,500
	(To record payment with no discount taken)		



A merchandising company usually should take all available discounts. Passing up the discount may be viewed as **paying interest** for use of the money. For example, passing up the discount offered by PW Audio Supply would be comparable to Sauk Stereo paying an interest rate of 2% for the use of €3,500 for 20 days. This is the equivalent of an annual interest rate of approximately 36.5% (2% × 365/20). Obviously, it would be better for Sauk Stereo to borrow at prevailing bank interest rates of 6% to 10% than to lose the discount.

Summary of Purchasing Transactions

The following T-account (with transaction descriptions in red) provides a summary of the effect of the previous transactions on Inventory.

1. Sauk Stereo originally purchased €3,800 worth of inventory on account for resale (May 4).
2. It paid €150 in freight charges (May 6).
3. It returned €300 of goods (May 8).
4. It received a €70 discount off the balance owed because it paid within the discount period (May 14).

This results in a balance in Inventory of €3,580.

	Inventory				
Purchase	May 4	3,800	May 8	300	**Purchase return**
Freight-in	6	150	14	70	**Purchase discount**
Balance		3,580			

DO IT! 2

Purchase Transactions

On September 5, Zhū Company buys merchandise on account from Gāo Company. The purchase price of the goods paid by Zhū is ¥15,000, and the cost to Gāo Company is ¥8,000. On September 8, Zhū returns defective goods with a selling price of ¥2,000. Record the transactions on the books of Zhū Company.

ACTION PLAN

- **Purchaser records goods at cost.**
- **When goods are returned, purchaser reduces Inventory.**

Solution

Related exercise material: BE5.2, BE5.4, DO IT! 5.2, E5.2, E5.3, E5.4, and E5.11.

5.3 Recording Sales Under a Perpetual System

LEARNING OBJECTIVE 3

Record sales under a perpetual inventory system.

In accordance with the revenue recognition principle, companies record sales revenue when the performance obligation is satisfied. Typically, the performance obligation is satisfied when the goods transfer from the seller to the buyer. At this point, the sales transaction is complete and the sales price established.

Sales may be made on credit or for cash. A **business document** should support every sales transaction, to provide written evidence of the sale.

- **Cash register documents** provide evidence of cash sales.
- A **sales invoice**, like the one shown in Illustration 5.6, provides support for a credit sale. The original copy of the invoice goes to the customer, and the seller keeps a copy for use in recording the sale.
- The invoice shows the date of sale, customer name, total sales price, and other relevant information.

The seller makes two entries for each sale.

1. **To record the sale**, seller increases (debits) Cash (or Accounts Receivable, if a credit sale), and also increases (credits) Sales Revenue.
2. **To record the cost of the merchandise sold**, the seller increases (debits) Cost of Goods Sold, and also decreases (credits) Inventory for the cost of those goods.

As a result, the Inventory account will show at all times the amount of inventory that should be on hand.

To illustrate a credit sales transaction, PW Audio Supply records its May 4 sale of €3,800 to Sauk Stereo (see Illustration 5.6) as follows (assume the merchandise cost PW Audio Supply €2,400).

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800
	(To record credit sale to Sauk Stereo per invoice #731)		
4	Cost of Goods Sold	2,400	
	Inventory		2,400
	(To record cost of merchandise sold on invoice #731 to Sauk Stereo)		

For internal decision-making purposes, merchandising companies may use more than one sales account. For example, PW Audio Supply may decide to keep separate sales accounts for its sales of TVs, Blu-ray players, and headsets. **Carrefour** might use separate accounts for sporting goods, children's clothing, and hardware—or it might have even more narrowly defined accounts. By using separate sales accounts for major product lines, rather than a single combined sales account, company management can more closely monitor sales trends and respond to changes in sales patterns more strategically. For example, if TV sales are increasing while Blu-ray player sales are decreasing, PW Audio Supply might reevaluate both its advertising and pricing policies on these items to ensure they are optimal.

On its income statement presented to outside investors, a merchandising company normally would provide only a single sales figure—the sum of all of its individual sales accounts. This is done for two reasons.

1. Providing detail on all of its individual sales accounts would add considerable length to its income statement.
2. Most companies do not want their competitors to know the details of their operating results.

However, **Microsoft** (USA) at one point expanded its disclosure of revenue from three to five types. The reason: The additional categories will better enable financial statement users to evaluate the growth of the company's consumer and Internet businesses.

At the end of "Anatomy of a Fraud" stories, which describe some recent real-world frauds, we discuss the missing control activities that would likely have prevented or uncovered the fraud.

Anatomy of a Fraud[1]

Holly Harmon was a cashier at a national superstore for only a short while when she began stealing merchandise using three methods.

1. Holly's husband or friends took UPC labels from cheaper items and put them on more expensive items. Holly then scanned the goods at the register.
2. Holly scanned an item at the register but then voided the sale and left the merchandise in the shopping cart.
3. Holly put goods into large plastic containers. She scanned the plastic containers but not the goods within them.

After Holly quit, a review of past surveillance tapes enabled the store to observe the thefts and to identify the participants.

Total take: $12,000

The Missing Controls

Human resource controls. A background check would have revealed Holly's previous criminal record. She would not have been hired as a cashier.

Physical controls. Software can flag high numbers of voided transactions or a high number of sales of low-priced goods. Random comparisons of video records with cash register records can ensure that the goods reported as sold on the register are the same goods that are shown being purchased on the video recording. Finally, employees should be aware that they are being monitored.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 251–259.

Sales Returns and Allowances

We now look at the "flip side" of purchase returns and allowances, which the seller records as **sales returns and allowances**. These are transactions where the seller either accepts goods back from the buyer (a return) or grants a reduction in the purchase price (an allowance) so the buyer will keep the goods.

PW Audio Supply's entries to record credit for returned goods involve (1) an increase (debit) in Sales Returns and Allowances (a contra account to Sales Revenue) and a decrease (credit) in Accounts Receivable at the €300 selling price, and (2) an increase (debit) in Inventory (assume a €140 cost) and a decrease (credit) in Cost of Goods Sold, as shown below (assuming that the goods were not defective).

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	(To record credit granted to Sauk Stereo for returned goods)		
8	Inventory	140	
	Cost of Goods Sold		140
	(To record cost of goods returned)		

If Sauk Stereo returns goods because they are damaged or defective, then PW Audio Supply's entry to Inventory and Cost of Goods Sold should be for the net realizable value of the returned goods, rather than their cost. (Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.) For example, if the returned goods were defective and had a net realizable value of €50, PW Audio Supply would debit Inventory for €50, and would credit Cost of Goods Sold for €50.

What happens if the goods are not returned but the seller grants the buyer an allowance by reducing the purchase price?

- In this case, the seller debits Sales Returns and Allowances and credits Accounts Receivable for the amount of the allowance.
- An allowance has no impact on Inventory or Cost of Goods Sold.

Sales Returns and Allowances is a **contra revenue account** to Sales Revenue. This means that it is offset against a revenue account on the income statement. The normal balance of Sales Returns and Allowances is a debit. Companies use a contra account, instead of debiting Sales Revenue, to disclose in the accounts and in the income statement the amount of sales returns and allowances.

Disclosure of this information is important to management.

- Excessive returns and allowances may suggest problems—inferior merchandise, inefficiencies in filling orders, errors in billing customers, or delivery or shipment mistakes.
- A decrease (debit) recorded directly to Sales Revenue would obscure the relative importance of sales returns and allowances as a percentage of sales. It also could distort comparisons between total sales in different accounting periods.

At the end of the accounting period, if the company anticipates that sales returns and allowances will be material, the company should make an adjusting entry to estimate the amount of returns. In some industries, such as those relating to the sale of books and periodicals, returns are often material. The accounting for situations where returns must be estimated is described in more detail in Appendix 5C.

Accounting Across the Organization

Tesco

Merchandiser's Accounting Causes Alarm

Accounting for merchandising transactions is not always as easy as it might first appear. Recently, **Tesco** (GBR) announced that it had overstated profits by £263 million over a three-year period. The error related to how Tesco accounted for amounts received from suppliers for promotional activities of those companies' products.

When a retailer runs advertisements promoting a particular product, the producer of that product shares part of the advertising cost. Typically, the producer pays the merchandiser its share of the advertising cost as much as a year before the advertisement is run. The questions become, how should these amounts be reported by the merchandiser at the time it receives the funds, and when should these amounts affect income?

The scandal surrounding this accounting treatment was serious enough that it caused the company's chairman to resign, and an outside auditing firm was brought in to investigate. One analyst commentated that "we can never recall a period so damaging to the reputation of the company."

Source: Adapted from Jenny Anderson, "Tesco Chairman to Step Down as Overstatement of Profit Grows," *The New York Times Online* (October 23, 2014).

Why would an error of this type be of concern to investors, and what steps did the company take to address these concerns?

Answer

Sales Discounts

As mentioned in our discussion of purchase transactions, the seller may offer the customer a cash discount—called by the seller a **sales discount**—for the prompt payment of the balance due.

- Like a purchase discount, a sales discount is based on the invoice price less returns and allowances, if any.
- The seller increases (debits) the Sales Discounts account for discounts that are taken.

For example, PW Audio Supply makes the following entry to record the cash receipt on May 14 from Sauk Stereo within the discount period.

May 14	Cash	3,430	
	Sales Discounts	70	
	Accounts Receivable		3,500
	(To record collection within 2/10, n/30 discount period from Sauk Stereo)		

Like Sales Returns and Allowances, Sales Discounts is a **contra revenue account** to Sales Revenue. Its normal balance is a debit. PW Audio Supply uses this account, instead of debiting Sales Revenue, to disclose the amount of cash discounts taken by customers. If Sauk Stereo does not take the discount, PW Audio Supply increases (debits) Cash for €3,500 and decreases (credits) Accounts Receivable for the same amount at the date of collection.

At the end of the accounting period, if the amount of potential discounts is material, the company should make an adjusting entry to estimate the discounts. This would not usually be the case for sales discounts but might be

necessary for other types of discounts such as volume discounts, which are addressed in more advanced accounting courses.

The following T-accounts summarize the three sales-related transactions and show their combined effect on net sales.

Data Analytics and Credit Sales

Increased access to ever larger amounts of data about customers, suppliers, products, and virtually every other aspect of a business has resulted in a greater reliance by companies on data analytics to support business decisions. Credit sales, sales returns and allowances, and sales discounts all provide rich opportunities for the use of data analytics.

- Effectively analyzing data regarding current, as well as potential, customers can help a company expand its sales base while minimizing the risk of unpaid receivables.
- In recent years, U.S. companies such as **Best Buy**, **REI**, and **Costco** have all refined their customer return policies, sometimes with unique rules for specific product types, as a result of data analytics applied to their data on product returns.
- To achieve the optimal cost-benefit balance on sales discounts, companies statistically analyze past discount practices to determine how large the discount should be, how long the payment period should be, and other factors.

Further, **Amazon** (USA) now uses artificial intelligence to decide whether it would be more profitable to process a return or simply refund a customer's money without return of the product. Amazon also uses algorithms to detect fraudulent returns by cybercriminals.

DO IT! 3

Sales Transactions

On September 5, Zhū Company buys merchandise on account from Gāo Company. The selling price of the goods is ¥15,000, and the cost to Gāo Company was ¥8,000. On September 8, Zhū returns defective goods with a selling price of ¥2,000 and a net realizable value of ¥300. Record the transactions on the books of Gāo Company.

ACTION PLAN

- **Seller records both the sale and the cost of goods sold at the time of the sale.**
- **When goods are returned, the seller records the return in a contra account, Sales Returns and Allowances, and reduces Accounts Receivable.**
- **Any goods returned increase Inventory and reduce Cost of Goods Sold. Defective or damaged inventory is recorded at net realizable value.**

Solution

Related exercise material: **BE5.2**, **BE5.3**, **DO IT! 5.3**, **E5.3**, **E5.4**, **E5.5**, **and E5.11**.

5.4 The Accounting Cycle for a Merchandising Company

LEARNING OBJECTIVE 4

Apply the steps in the accounting cycle to a merchandising company.

Up to this point, we have illustrated the basic entries for transactions relating to purchases and sales in a perpetual inventory system. Now we consider the remaining steps in the accounting cycle for a merchandising company. Each of the required steps described in Chapter 4 for service companies apply to merchandising companies. Appendix 5A shows the use of a worksheet by a merchandiser (an optional step).

Adjusting Entries

A merchandising company generally has the same types of adjusting entries as a service company. However, a merchandiser using a perpetual system will require one additional adjustment to make the records agree with the actual inventory on hand. Here's why.

- At the end of each period, for control purposes, a merchandising company that uses a perpetual system will take a physical count of its goods on hand.

- The company's unadjusted balance in Inventory usually does not agree with the actual amount of inventory on hand. The perpetual inventory records may be incorrect due to recording errors, theft, or waste.
- Thus, the company needs to adjust the perpetual records to make the recorded inventory amount agree with the inventory on hand. **This involves adjusting Inventory and Cost of Goods Sold.**

For example, suppose that PW Audio Supply has an unadjusted balance of €40,500 in Inventory. Through a physical count, PW Audio Supply determines that its actual merchandise inventory at December 31 is €40,000. The company would make an adjusting entry as follows.

Dec. 31	Cost of Goods Sold	500	
	Inventory (€40,500 – €40,000)		500
	(To adjust inventory to physical count)		

Closing Entries

A merchandising company, like a service company, closes to Income Summary all accounts that affect net income. In journalizing, the company credits all temporary accounts with debit balances, and debits all temporary accounts with credit balances, as the following shows for PW Audio Supply (see Helpful Hint). Note that PW Audio Supply closes Cost of Goods Sold to Income Summary.

> **HELPFUL HINT**
>
> **The easiest way to prepare the first two closing entries is to identify the temporary accounts by their balances and then prepare one entry for the credits and one for the debits.**

Dec. 31	Sales Revenue	480,000	
	Income Summary		480,000
	(To close income statement accounts with credit balances)		
31	Income Summary	450,000	
	Cost of Goods Sold		316,000
	Salaries and Wages Expense		64,000
	Utilities Expense		17,000
	Advertising Expense		16,000
	Sales Returns and Allowances		12,000
	Sales Discounts		8,000
	Depreciation Expense		8,000
	Freight-Out		7,000
	Insurance Expense		2,000
	(To close income statement accounts with debit balances)		
31	Income Summary	30,000	
	Retained Earnings		30,000
	(To close net income to retained earnings)		
31	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends to retained earnings)		

After PW Audio Supply has posted the closing entries, all temporary accounts have zero balances. Also, Retained Earnings has a balance that is carried over to the next period.

Summary of Merchandising Entries

Illustration 5.8 summarizes the entries for the merchandising accounts using a perpetual inventory system.

ILLUSTRATION 5.8 Daily recurring and adjusting and closing entries

DO IT! 4

Closing Entries

The trial balance of Celine's Sports Wear Shop at December 31 shows Inventory €25,000, Sales Revenue €162,400, Sales Returns and Allowances €4,800, Sales Discounts €3,600, Cost of Goods Sold €110,000, Rent Revenue €6,000, Freight-Out €1,800, Rent Expense €8,800, and Salaries and Wages Expense €22,000. Prepare the closing entries for the above accounts.

ACTION PLAN

- **Close all temporary accounts with credit balances to Income Summary by debiting these accounts.**
- **Close all temporary accounts with debit balances, except Dividends, to Income Summary by crediting these accounts.**

Solution

Related exercise material: **BE5.5**, **BE5.6**, **DO IT! 5.4**, **E5.6**, **E5.7**, **and** **E5.8**.

5.5 Financial Statements for a Merchandiser

LEARNING OBJECTIVE 5

Prepare financial statements for a merchandising company.

Merchandising companies widely use the classified statement of financial position introduced in Chapter 4. This section explains an income statement used by merchandisers and provides additional information related to the statement of financial position.

Income Statement

The income statement is a primary source of information for evaluating a company's performance. The format is designed to differentiate between the various sources of income and expense.

Income Statement Presentation of Sales

The income statement begins by presenting **sales revenue**. It then deducts contra revenue accounts—sales returns and allowances and sales discounts—from sales revenue to arrive at **net sales**. **Illustration 5.9** presents the sales section for PW Audio Supply, using assumed data.

ILLUSTRATION 5.9 Computation of net sales

PW Audio Supply
Income Statement (partial)

Sales		
Sales revenue		€480,000
Less: Sales returns and allowances	€12,000	
Sales discounts	8,000	20,000
Net sales		**€460,000**

This presentation discloses the key data about the company's principal revenue-producing activities.

Gross Profit

From Illustration 5.1, you learned that companies deduct cost of goods sold from sales revenue in order to determine **gross profit** (see **Alternative Terminology**). For this computation, companies use **net sales** (which takes into consideration Sales Returns and Allowances and Sales Discounts) as the amount of sales revenue. On the basis of the sales data in Illustration 5.9 (net sales of €460,000) and cost of goods sold under the perpetual inventory system (assume €316,000), PW Audio Supply's gross profit is €144,000, computed as shown in **Illustration 5.10**.

ALTERNATIVE TERMINOLOGY

Gross profit is sometimes referred to as *gross margin*.

ILLUSTRATION 5.10 Computation of gross profit

Net sales	€460,000
Cost of goods sold	316,000
Gross profit	**€144,000**

We also can express a company's gross profit as a percentage, called the **gross profit rate**. To do so, we divide the amount of gross profit by net sales. For PW Audio Supply, the **gross profit rate** is 31.3%, computed as shown in Illustration 5.11.

ILLUSTRATION 5.11 Gross profit rate formula and computation

Gross Profit	÷	Net Sales	=	Gross Profit Rate
€144,000	÷	€460,000	=	31.3%

- Analysts generally consider the gross profit **rate** to be more useful than the gross profit **amount**.
- The rate expresses a more meaningful (qualitative) relationship between net sales and gross profit.

For example, a gross profit of €1,000,000 may sound impressive. But if it is the result of a gross profit rate of only 7% when others in the industry get 20%, it is not so impressive. The gross profit rate tells how much of each euro of sales goes to gross profit.

Gross profit represents the **merchandising profit** of a company. It is not a measure of the overall profitability, because operating expenses are not yet deducted. But managers and other interested parties closely watch the amount and trend of gross profit.

- Managers compare current gross profit with amounts reported in past periods.
- They also compare the company's gross profit rate with rates of competitors and with industry averages.
- Such comparisons provide information about the effectiveness of a company's purchasing function and the soundness of its pricing policies.

Operating Expenses

Operating expenses are the next component in the income statement of a merchandising company. They are the expenses incurred in the process of earning sales revenue. Many of these expenses are similar in merchandising and service companies. At PW Audio Supply, operating expenses were €114,000. This €114,000 includes costs that were incurred for salaries, utilities, advertising, depreciation, freight-out, and insurance. The presentation of operating expenses is shown in Illustration 5.12.

ILLUSTRATION 5.12 Operating expenses

Operating expenses	
Salaries and wages expense	€ 64,000
Utilities expense	17,000
Advertising expense	16,000
Depreciation expense	8,000
Freight-out	7,000
Insurance expense	2,000
Total operating expenses	€114,000

Illustration 5.12 provides an opportunity to discuss two different presentation formats allowed by IFRS: **presentation by nature** and **presentation by function**.

- Presentation by nature provides very detailed information, with numerous line items, that reveal the nature of costs incurred by the company. In Illustration 5.12, the detailed information regarding costs incurred for salaries and wages, utilities, advertising, depreciation, freight-out, and insurance demonstrates presentation by nature.
- Presentation by function aggregates costs into groupings based on the primary functional activities in which the company engages. For example, at PW Audio Supply, operating expenses are those costs incurred to perform the operating functions of a merchandising business. If PW Audio Supply chose to present strictly by function, it would present its operating expenses as a single line item of €114,000.

However, if a presentation by function is used, IFRS requires disclosure of additional details regarding the nature of certain expenses that were included in the functional grouping. For example, depreciation and salary and wage costs are items specifically required to be disclosed.

Illustration 5.12 combines both a presentation by function and by nature to present operating expenses. It uses a functional grouping of operating expenses but also presents in detail the nature of the costs included in that functional grouping. *In your homework, you should use this approach*.

Other Income and Expense

Other income and expense consists of various revenues and gains and expenses and losses that are unrelated to the company's main line of operations. **Illustration 5.13** lists examples of each.

ILLUSTRATION 5.13 Examples of other income and expense

Other Income
Interest revenue from notes receivable and marketable securities.
Dividend revenue from investments in ordinary shares.
Rent revenue from subleasing a portion of the store.
Gain from the sale of property, plant, and equipment.
Other Expense
Casualty losses from such causes as vandalism and accidents.
Loss from the sale or abandonment of property, plant, and equipment.
Loss from strikes by employees and suppliers.

Merchandising companies report other income and expense in the income statement immediately after the company's primary operating activities. **Illustration 5.14** shows this presentation for PW Audio Supply.

Interest Expense

Financing activities, which result in interest expense, represent distinctly different types of cost to a business. In evaluating the performance of a business, it is important to monitor its interest expense. As a consequence, interest expense, if material, must be disclosed on the face of the income statement. PW Audio Supply incurred interest expense of €1,800. Illustration 5.14 presents a complete income statement for PW Audio Supply. *Use this format when preparing your homework*.

ILLUSTRATION 5.14 **Income statement**

PW Audio Supply
Income Statement
For the Year Ended December 31, 2025

Sales		
Sales revenue		€480,000
Less: Sales returns and allowances	€12,000	
Sales discounts	8,000	20,000
Net sales		460,000
Cost of goods sold		316,000
Gross profit		144,000
Operating expenses		
Salaries and wages expense	64,000	
Utilities expense	17,000	
Advertising expense	16,000	
Depreciation expense	8,000	
Freight-out	7,000	
Insurance expense	2,000	
Total operating expenses		114,000
Income from operations		30,000
Other income and expense		
Interest revenue	3,000	
Gain on sale of equipment	600	
Casualty loss from vandalism	(200)	3,400
Interest expense		1,800
Net income		€ 31,600

Comprehensive Income

Chapter 1 discussed the current value basis. IFRS requires companies to adjust the recorded values of certain types of assets and liabilities to their current values at the end of each reporting period. In some instances, the unrealized gains or losses that result from adjusting recorded amounts to current value are included in net income. However, in other cases, these unrealized gains and losses are not included in net income.

- These excluded items are reported as part of a more inclusive earnings measure, called **comprehensive income**.
- Examples of such items include certain adjustments to pension plan assets, gains and losses on foreign currency translation, and unrealized gains and losses on certain types of investments.
- Items that are excluded from net income but included in comprehensive income are either reported in a combined statement of net income and comprehensive income, or in a separate schedule that reports only comprehensive income.

Illustration 5.15 shows how comprehensive income is presented in a separate **comprehensive income statement**, assuming that PW Audio Supply had other comprehensive income of €2,300. *Use this format when preparing your homework.*

ILLUSTRATION 5.15 Separate statement of net income and comprehensive income

PW Audio Supply Comprehensive Income Statement For the Year Ended December 31, 2025	
Net income	€31,600
Other comprehensive income	
Unrealized holding gain on investment securities	2,300
Comprehensive income	€33,900

PW Audio Supply
Comprehensive Income Statement
For the Year Ended December 31, 2025

Accounting Across the Organization

Alibaba

A Store with a Billion Items?

The rise of e-commerce has created some unique challenges and opportunities for businesses. Consider the challenge and opportunity face by **Alibaba** (CHN). Alibaba has become incredibly effective at attracting customers and sellers. It currently has a virtual store with over a billion different inventory items.

Since the store is virtual, physical space is not an issue. The problem is that consumers only have so much time to look for items. In response, using machine learning and artificial intelligence, Alibaba has built the ability to create customer-specific or personalized web pages. When customers search for an item, they will receive customized suggestions for additional items they may have an interest in based on their past purchases and the purchases of other customers.

How successful have Alibaba's efforts been? During a recent 11.11 Global Shopping Festival, Alibaba generated 6.7 billion personalized shopping pages, connecting consumers to 230,000 different merchants. The personalized shopping pages generated an additional 20% of recommended items sold compared to non-personalized pages.

Source: Adapted from "At Alibaba, Artificial Intelligence is Changing How People Shop Online," *alizila.com* (June 5, 2017).

Increased revenue has to be compared to increased costs. What sort of additional costs do you think Alibaba has to incur to offer personalized shopping pages?

Answer

Classified Statement of Financial Position

In the statement of financial position, merchandising companies report inventory as a current asset immediately above accounts receivable. Recall from Chapter 4 that companies generally list current asset items in the reverse order of their closeness to cash (liquidity). Inventory is less close to cash than accounts receivable because the goods must first be sold and then collection made from the customer. **Illustration 5.16** presents the assets section of a classified statement of financial position for PW Audio Supply (see **Helpful Hint**).

ILLUSTRATION 5.16 Assets section of a classified statement of financial position

PW Audio Supply
Statement of Financial Position (Partial)
December 31, 2025

Assets		
Property, plant, and equipment		
Equipment	€80,000	
Less: Accumulated depreciation—equipment	24,000	€ 56,000
Current assets		
Prepaid insurance	1,800	
Inventory	40,000	
Accounts receivable	16,100	
Cash	9,500	67,400
Total assets		€123,400

HELPFUL HINT

The €40,000 is the cost of the inventory on hand, not its expected selling price.

DO IT! 5

Financial Statement Classifications

You are presented with the following list of accounts from the adjusted trial balance for merchandiser Gorman Company. Indicate in which financial statement (income statement, IS; statement of financial position, SFP; or retained earnings statement, RES) and under what classification each of the following would be reported.

Accounts Payable	Interest Expense
Accounts Receivable	Interest Payable
Accumulated Depreciation—Buildings	Inventory
Accumulated Depreciation—Equipment	Land
Advertising Expense	Notes Payable (due in 3 years)
Buildings	Property Taxes Payable
Cash	Salaries and Wages Expense
Depreciation Expense	Salaries and Wages Payable
Dividends	Sales Returns and Allowances
Equipment	Sales Revenue
Freight-Out	Share Capital—Ordinary
Gain on Disposal of Plant Assets	Utilities Expense
Insurance Expense	

ACTION PLAN

- **Review the major sections of the income statement: sales, cost of goods sold, operating expenses, other income and expense, and interest expense.**
- **Add net income to beginning retained earnings and deduct dividends to arrive at ending retained earnings in the retained earnings statement.**
- **Review the major sections of the statement of financial position, income statement, and retained earnings statement.**

Solution

Related exercise material: **BE5.7**, **BE5.8**, **BE5.9**, **DO IT! 5.5**, **E5.9**, **E5.10**, **E5.12**, **E5.13**, **and E5.14**.

Appendix 5A Worksheet for a Merchandising Company

LEARNING OBJECTIVE *6

Prepare a worksheet for a merchandising company.

Using a Worksheet

As indicated in Chapter 4, a worksheet enables companies to prepare financial statements before they journalize and post adjusting entries. The steps in preparing a worksheet for a merchandising company are the same as for a service company. **Illustration 5A.1** shows the worksheet for PW Audio Supply (excluding non-operating items). The unique accounts for a merchandiser using a perpetual inventory system are shown in capital red letters. This worksheet assumes that the company did not have comprehensive income.

ILLUSTRATION 5A.1 Worksheet for merchandising company

Trial Balance Columns

Data for the trial balance come from the ledger balances of PW Audio Supply at December 31. The amount shown for Inventory, €40,500, is the year-end inventory amount from the perpetual inventory system.

Adjustments Columns

A merchandising company generally has the same types of adjustments as a service company. As you see in the worksheet, adjustments (b), (c), and (d) are for insurance, depreciation, and salaries and wages. Yazici Advertising, as illustrated in Chapters 3 and 4, also had these adjustments. Adjustment (a) was required to adjust the perpetual inventory carrying amount to the actual count.

After PW Audio Supply enters all adjustments data on the worksheet, it establishes the equality of the adjustments column totals. It then extends the balances in all accounts to the adjusted trial balance columns.

Adjusted Trial Balance

The adjusted trial balance shows the balance of all accounts after adjustment at the end of the accounting period.

Income Statement Columns

Next, the merchandising company transfers the accounts and balances that affect the income statement from the adjusted trial balance columns to the income statement columns. PW Audio Supply shows sales of €480,000 in the credit column. It shows the contra revenue accounts Sales Returns and Allowances €12,000 and Sales Discounts €8,000 in the debit column. The difference of €460,000 is the net sales shown on the income statement (Illustration 5.14).

Finally, the company totals all the credits in the income statement column and compares those totals to the total of the debits in the income statement column. If the credits exceed the debits, the company has net income. PW Audio Supply has net income of €30,000. If the debits exceed the credits, the company would report a net loss.

Statement of Financial Position Columns

The major difference between the statements of financial position of a service company and a merchandiser is inventory. PW Audio Supply shows the ending inventory amount of €40,000 in the statement of financial position debit column. The information to prepare the retained earnings statement is also found in these columns. That is, the retained earnings beginning balance is €33,000. Dividends are €15,000. Net income results when the total of the debit column exceeds the total of the credit column in the statement of financial position columns. A net loss results when the total of the credits exceeds the total of the debit balances.

Appendix 5B Periodic Inventory System

> **LEARNING OBJECTIVE *7**
>
> Record purchases and sales under a periodic inventory system.

As described in this chapter, companies may use one of two basic systems of accounting for inventories: (1) the perpetual inventory system or (2) the periodic inventory system. In the chapter, we focused on the characteristics of the perpetual inventory system.

In this appendix, we discuss and illustrate the **periodic inventory system**. One key difference between the two systems is the point at which the company computes cost of goods sold. For a visual reminder of this difference, refer back to Illustration 5.5.

Determining Cost of Goods Sold Under a Periodic System

Determining cost of goods sold is different when a periodic inventory system is used rather than a perpetual system. As you have seen, a company using a **perpetual system** makes an entry to record cost of goods sold and to reduce inventory each time a sale is made.

- A company using a **periodic system** does not determine cost of goods sold until the end of the period.
- At the end of the period, the company performs a count to determine the ending balance of inventory.
- It then **calculates cost of goods sold by subtracting ending inventory from the cost of goods available for sale**.

Cost of goods available for sale is the sum of beginning inventory plus cost of goods purchased, as shown in **Illustration 5B.1**.

ILLUSTRATION 5B.1 Basic formula for cost of goods sold using the periodic system

	Beginning Inventory
+	Cost of Goods Purchased
	Cost of Goods Available for Sale
–	Ending Inventory
	Cost of Goods Sold

Another difference between the two approaches is that the perpetual system directly adjusts the Inventory account for any transaction that affects inventory (such as freight costs, returns, and discounts). The periodic system does not do this. Instead, it creates different accounts for purchases, freight costs, returns, and discounts. These various accounts are shown in **Illustration 5B.2**, which presents the calculation of cost of goods sold for PW Audio Supply using the periodic approach (see **Helpful Hint**).

ILLUSTRATION 5B.2 Cost of goods sold for a merchandiser using a periodic inventory system

PW Audio Supply
Cost of Goods Sold
For the Year Ended December 31, 2025

Cost of goods sold			
Inventory, January 1			**€ 36,000**
Purchases		€325,000	
Less: Purchase returns and allowances	€10,400		
Purchase discounts	6,800	17,200	
Net purchases		307,800	
Add: Freight-in		12,200	
Cost of goods purchased			**320,000**
Cost of goods available for sale			**356,000**
Less: Inventory, December 31			**40,000**
Cost of goods sold			**€316,000**

HELPFUL HINT

The far right column identifies the primary items that make up cost of goods sold of €316,000. The middle column explains cost of goods purchased of €320,000. The left column reports contra purchase items of €17,200.

Note that the basic elements from Illustration 5B.1 are highlighted in Illustration 5B.2. You will learn more in Chapter 6 about how to determine cost of goods sold using the periodic system.

The use of the periodic inventory system does not affect the form of presentation in the statement of financial position. As under the perpetual system, a company reports inventory in the current assets section.

Recording Merchandise Transactions

In a **periodic inventory system**, companies record revenues from the sale of merchandise when sales are made, just as in a perpetual system. Unlike the perpetual system, however, companies **do not attempt on the date of sale to record the cost of the merchandise sold**.

- Under a periodic system, companies take a physical inventory count at the **end of the period** to determine (1) the cost of the merchandise then on hand and (2) the cost of the goods sold during the period.
- And, **under a periodic system, companies record purchases of merchandise in the Purchases account rather than the Inventory account**.

Purchase returns and allowances, purchase discounts, and freight costs on purchases are recorded in separate accounts.

To illustrate the recording of merchandise transactions under a periodic inventory system, we will use purchase/sales transactions between PW Audio Supply and Sauk Stereo, as illustrated for the perpetual inventory system in this chapter.

Recording Purchases of Merchandise

On the basis of the sales invoice (Illustration 5.6) and receipt of the merchandise ordered from PW Audio Supply, Sauk Stereo records the €3,800 purchase as follows (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Be careful not to debit purchases of equipment or supplies to a Purchases account.**

May 4	Purchases	3,800	
	Accounts Payable		3,800
	(To record goods purchased on account from PW Audio Supply)		

Purchases is a temporary account whose normal balance is a debit.

Freight Costs

When the purchaser directly incurs the freight costs, it debits the account Freight-In (or Transportation-In). For example, if Sauk Stereo pays Acme Freight Company €150 for freight charges on its purchase from PW Audio Supply on May 6, the entry on Sauk Stereo's books is as follows.

May 6	Freight-In (Transportation-In)	150	
	Cash		150
	(To record payment of freight on goods purchased)		

Like Purchases, Freight-In is a temporary account whose normal balance is a debit. **Freight-In is part of cost of goods purchased.** The reason is that cost of goods purchased should include any freight charges necessary to bring the goods to the purchaser. Freight costs are not subject to a purchase discount. Purchase discounts apply only to the invoice cost of the merchandise.

Purchase Returns and Allowances

Sauk Stereo returns goods costing €300 to PW Audio Supply and prepares the following entry to recognize the return.

May 8	Accounts Payable	300	
	Purchase Returns and Allowances		300
	(To record return of goods purchased from PW Audio Supply)		

Purchase Returns and Allowances is a temporary account whose normal balance is a credit.

Purchase Discounts

On May 14, Sauk Stereo pays the balance due on account to PW Audio Supply, taking the 2% cash discount allowed by PW Audio Supply for payment within 10 days. Sauk Stereo records the payment and discount as follows.

May 14	Accounts Payable (€3,800 − €300)	3,500	
	Purchase Discounts (€3,500 × .02)		70
	Cash		3,430
	(To record payment within the discount period)		

Purchase Discounts is a temporary account whose normal balance is a credit.

Recording Sales of Merchandise

The seller, PW Audio Supply, records the sale of €3,800 of merchandise to Sauk Stereo on May 4 (sales invoice No. 731, Illustration 5.6) as follows.

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800
	(To record credit sales per invoice #731 to Sauk Stereo)		

Sales Returns and Allowances

To record the returned goods received from Sauk Stereo on May 8, PW Audio Supply records the €300 sales return as follows.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	(To record credit granted to Sauk Stereo for returned goods)		

Sales Discounts

On May 14, PW Audio Supply receives payment of €3,430 on account from Sauk Stereo. PW Audio Supply honors the 2% cash discount and records the payment of Sauk Stereo's account receivable in full as follows.

May 14	Cash	3,430	
	Sales Discounts (€3,500 × .02)	70	
	Accounts Receivable (€3,800 − €300)		3,500
	(To record collection within 2/10, n/30 discount period from Sauk Stereo)		

Comparison of Entries—Perpetual vs. Periodic

Illustration 5B.3 summarizes the periodic inventory entries shown in this appendix and compares them to the perpetual-system entries from the chapter. Entries that differ in the two systems are shown in color.

Journalizing and Posting Closing Entries

For a merchandising company, like a service company, all accounts that affect the determination of net income are closed to Income Summary. Data for the preparation of closing entries may be obtained from the income statement columns of the worksheet. In journalizing, all debit column amounts are credited, and all credit columns amounts are debited. To close the merchandise inventory in a periodic inventory system:

1. The beginning inventory balance is debited to Income Summary and credited to Inventory.
2. The ending inventory balance is debited to Inventory and credited to Income Summary.

The two entries for PW Audio Supply are as follows.

	(1)		
Dec. 31	Income Summary	36,000	
	Inventory		36,000
	(To close beginning inventory)		
	(2)		
31	Inventory	40,000	
	Income Summary		40,000
	(To record ending inventory)		

ILLUSTRATION 5B.3 Comparison of entries for perpetual and periodic inventory systems

ENTRIES ON SAUK STEREO'S BOOKS

Transaction		Perpetual Inventory System			Periodic Inventory System		
May 4	Purchase of merchandise on credit.	Inventory	3,800		Purchases	3,800	
		Accounts Payable		3,800	Accounts Payable		3,800
6	Freight costs on purchases.	Inventory	150		Freight-In	150	
		Cash		150	Cash		150
8	Purchase returns and allowances.	Accounts Payable	300		Accounts Payable	300	
		Inventory		300	Purchase Returns and Allowances		300
14	Payment on account with a discount.	Accounts Payable	3,500		Accounts Payable	3,500	
		Cash		3,430	Cash		3,430
		Inventory		70	Purchase Discounts		70

ENTRIES ON PW AUDIO SUPPLY'S BOOKS

Transaction		Perpetual Inventory System			Periodic Inventory System		
May 4	Sale of merchandise on credit.	Accounts Receivable	3,800		Accounts Receivable	3,800	
		Sales Revenue		3,800	Sales Revenue		3,800
		Cost of Goods Sold	2,400		No entry for cost of goods sold		
		Inventory		2,400			
8	Return of merchandise sold.	Sales Returns and Allowances	300		Sales Returns and Allowances	300	
		Accounts Receivable		300	Accounts Receivable		300
		Inventory	140		No entry		
		Cost of Goods Sold		140			
14	Cash received on account with a discount.	Cash	3,430		Cash	3,430	
		Sales Discounts	70		Sales Discounts	70	
		Accounts Receivable		3,500	Accounts Receivable		3,500

Illustration 5B.4 shows the Inventory and Income Summary accounts after posting.

ILLUSTRATION 5B.4 Posting closing entries for merchandise inventory

Inventory

1/1	Bal.	36,000	12/31	Close	36,000
12/31	Close	40,000			
12/31	Bal.	40,000			

Income Summary

12/31	Close	36,000	12/31	Close	40,000

Often, the closing of Inventory is included with other closing entries, as shown for PW Audio Supply (see Helpful Hint). (*Close Inventory with other accounts in homework problems unless stated otherwise.*)

HELPFUL HINT

Except for merchandise inventory, the easiest way to prepare the first two closing entries is to identify the temporary accounts by their balances and then prepare one entry for the credits and one for the debits.

Dec. 31	**Inventory (Dec. 31)**	**40,000**	
	Sales Revenue	480,000	
	Purchase Returns and Allowances	10,400	
	Purchase Discounts	6,800	
	Income Summary		537,200
	(To record ending inventory and close accounts with credit balances)		
31	Income Summary	507,200	
	Inventory (Jan. 1)		**36,000**
	Sales Returns and Allowances		12,000
	Sales Discounts		8,000
	Purchases		325,000
	Freight-In		12,200
	Salaries and Wages Expense		64,000
	Freight-Out		7,000
	Advertising Expense		16,000
	Utilities Expense		17,000
	Depreciation Expense		8,000
	Insurance Expense		2,000
	(To close beginning inventory and other income statement accounts with debit balances)		
31	Income Summary	30,000	
	Retained Earnings		30,000
	(To transfer net income to retained earnings)		
31	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends to retained earnings)		

After the closing entries are posted, all temporary accounts have zero balances. In addition, Retained Earnings has a credit balance of €48,000: Beginning balance + Net income − Dividends (€33,000 + €30,000 − €15,000).

Using a Worksheet

As indicated in Chapter 4, a worksheet enables companies to prepare financial statements before journalizing and posting adjusting entries. The steps in preparing a worksheet for a merchandising company are the same as they are for a service company.

Trial Balance Columns

Data for the trial balance come from the ledger balances of PW Audio Supply at December 31. The amount shown for Inventory, €36,000, is the beginning inventory amount from the periodic inventory system.

Adjustments Columns

A merchandising company generally has the same types of adjustments as a service company. As you see in the worksheet in **Illustration 5B.5**, adjustments (a), (b), and (c) are for insurance, depreciation, and salaries and wages. These adjustments were also required for Yazici Advertising A.Ş., as illustrated in Chapters 3 and 4. The unique accounts for a merchandiser using a **periodic inventory system** are shown in capital red letters. Note, however, that the worksheet excludes non-operating items.

After all adjustment data are entered on the worksheet, the equality of the adjustment column totals is established. The balances in all accounts are then extended to the adjusted trial balance columns.

ILLUSTRATION 5B.5 Worksheet for merchandising company—periodic inventory system

Income Statement Columns

Next, PW Audio Supply transfers the accounts and balances that affect the income statement from the adjusted trial balance columns to the income statement columns. The company shows Sales Revenue of €480,000 in the credit column. It shows the contra revenue accounts, Sales Returns and Allowances of €12,000 and Sales Discounts of €8,000, in the debit column. The difference of €460,000 is the net sales shown on the income statement (Illustration 5.9). Similarly, Purchases of €325,000 and Freight-In of €12,200 are extended to the debit column. The contra purchase accounts, Purchase Returns and Allowances of €10,400 and Purchase Discounts of €6,800, are extended to the credit columns.

The worksheet procedures for the Inventory account merit specific comment:

1. The beginning balance, €36,000, is extended from the adjusted trial balance column to the **income statement debit column**. From there, it can be added in reporting cost of goods available for sale in the income statement.
2. The ending inventory, €40,000, is added to the worksheet by an **income statement credit and a statement of financial position debit**. The credit makes it possible to deduct ending inventory from the cost of goods available for sale in the income statement to determine cost of goods sold. The debit means the ending inventory can be reported as an asset on the statement of financial position.

Illustration 5B.6 shows these two procedures.

ILLUSTRATION 5B.6 Worksheet procedures for inventories

		Income Statement			Statement of Financial Position	
		Dr.	Cr.		Dr.	Cr.
Inventory	**(1)**	**36,000**	**40,000**	**←(2)→**	**40,000**	

The computation for cost of goods sold, taken from the income statement column in Illustration 5B.5, is as shown in Illustration 5B.7 (see Helpful Hint).

ILLUSTRATION 5B.7 Computation of cost of goods sold from worksheet columns

Debit Column		Credit Column	
Beginning inventory	€ 36,000	Ending inventory	€40,000
Purchases	325,000	Purchase returns and allowances	10,400
Freight-in	12,200	Purchase discounts	6,800
Total debits	373,200	Total credits	€57,200
Less: Total credits	57,200		
Cost of goods sold	**€316,000**		

> **HELPFUL HINT**
>
> **In a periodic system, cost of goods sold is a computation—it is not a separate account with a balance.**

Finally, PW Audio Supply totals all the credits in the income statement column and compares these totals to the total of the debits in the income statement column. If the credits exceed the debits, the company has net income. PW Audio Supply has net income of €30,000. If the debits exceed the credits, the company would report a net loss.

Statement of Financial Position Columns

The major difference between the statements of financial position of a service company and a merchandising company is inventory. PW Audio Supply shows ending inventory of €40,000 in the statement of financial position debit column. The information to prepare the retained earnings statement is also found in these columns. That is, the retained earnings beginning balance is €33,000. Dividends are €15,000. Net income results when the total of the debit column exceeds the total of the credit column in the statement of financial position columns. A net loss results when the total of the credits exceeds the total of the debit balances.

Appendix 5C Adjusting Entries for Credit Sales with Returns and Allowances

LEARNING OBJECTIVE *8

Prepare adjusting entries for credit sales with returns and allowances.

Sales returns are common for many types of businesses. As noted in the chapter, at the end of the accounting period a company must estimate the amount of goods sold during the period that will be returned in subsequent periods and accrue for this amount.

To illustrate the accounting for an estimated return situation, assume that Rainbow Company began operations on January 1, 2025. On January 12, 2025, Rainbow sells 100 pairs of shoes for $100 each **on account** to Tanner Inc. Rainbow allows Tanner to return any unused shoes within 45 days of purchase. The cost of each product is $60. Rainbow records the sale as follows.

Accounts Receivable	10,000	
Sales Revenue (100 × $100)		10,000
Cost of Goods Sold	6,000	
Inventory (100 × $60)		6,000
(To record the sale of shoes and related cost of goods sold)		

On January 24, Tanner returns two pairs of shoes because they were the wrong color. Rainbow records the return as follows.

Sales Returns and Allowances	200	
Accounts Receivable (2 × $100)		200
Inventory	120	
Cost of Goods Sold (2 × $60)		120
(To record the return of shoes)		

On January 31, Rainbow prepares monthly financial statements and estimates that it is likely that only one more pair of shoes will be returned. Rainbow records two adjusting entries to account for this estimate.

- The first entry requires a debit to Sales Returns and Allowances and a credit to Refund Liability for the selling price of the estimated returns.
- The second entry requires a debit to Estimated Inventory Returns and a credit to Cost of Goods Sold for the cost of the estimated returns.

Rainbow makes the following adjusting entries to account for expected return at January 31, 2025.

Sales Returns and Allowances	100	
Refund Liability (1 × $100)		100
(To record expected sales return)		
Estimated Inventory Returns	60	
Cost of Goods Sold (1 × $60)		60
(To record the expected return of shoes and related reduction in Cost of Goods Sold)		

Refund Liability is a liability account. It reflects the estimated future amount owed to customers in response to future returned goods. The Estimated Inventory Returns account will generally be added to the Inventory account at the end of the reporting period.

On February 18, Tanner returns another pair of shoes to Rainbow. Assuming that Tanner has not already paid Rainbow for the shoes, Rainbow records the entry as follows.

Refund Liability	100	
Accounts Receivable (1 × $100)		100
Inventory	60	
Estimated Inventory Returns (1 × $60)		60
(To record the return of shoes)		

If Tanner had initially paid for the shoes in cash or paid its balance due on a credit purchase prior to returning the shoes on February 18, Rainbow would credit Accounts Payable rather than Accounts Receivable as shown in the following entry.

Refund Liability	100	
Accounts Payable (1 × $100)		100
Inventory	60	
Estimated Inventory Returns (1 × $60)		60
(To record the return of shoes)		

Review and Practice

Learning Objectives Review

1 Describe merchandising operations and inventory systems.

Because of inventory, a merchandising company has sales revenue, cost of goods sold, and gross profit. To account for inventory, a merchandising company must choose between a perpetual and a periodic inventory system.

2 Record purchases under a perpetual inventory system.

The company debits the Inventory account for all purchases of merchandise and freight-in, and credits it for purchase discounts and purchase returns and allowances.

3 Record sales under a perpetual inventory system.

When a merchandising company sells inventory, it debits Accounts Receivable (or Cash) and credits Sales Revenue for the selling price of the merchandise. At the same time, it debits Cost of Goods Sold and credits Inventory for the cost of the inventory items sold. Sales Returns and Allowances and Sales Discounts are debited and are contra revenue accounts.

4 Apply the steps in the accounting cycle to a merchandising company.

Each of the required steps in the accounting cycle for a service company applies to a merchandising company. A worksheet is again an optional step. Under a perpetual inventory system, the company must adjust the Inventory account to agree with the physical count.

5 Prepare financial statements for a merchandising company.

The income statement has the following components: sales, cost of goods sold, gross profit, operating expenses, other income and expense, and interest expense. A comprehensive income statement adds or subtracts any items of other comprehensive income from net income to arrive at comprehensive income.

***6 Prepare a worksheet for a merchandising company.**

The steps in preparing a worksheet for a merchandising company are the same as for a service company. The unique accounts for a merchandiser are Inventory, Sales Revenue, Sales Returns and Allowances, Sales Discounts, and Cost of Goods Sold.

***7 Record purchases and sales under a periodic inventory system.**

In recording purchases under a periodic system, companies must make entries for (a) cash and credit purchases, (b) purchase returns and allowances, (c) purchase discounts, and (d) freight costs. In recording sales, companies must make entries for (a) cash and credit sales, (b) sales returns and allowances, and (c) sales discounts.

***8 Prepare adjusting entries for credit sales with returns and allowances.**

Adjusting credit sales for returns and allowances requires two entries at the end of the period. The first entry requires a debit to Sales Returns and Allowances and a credit to Refund Liability for the selling price of the estimated returns. The second entry requires a debit to Estimated Inventory Returns and a credit to Cost of Goods Sold for the cost of the estimated returns. Refund Liability is a liability account and reflects the estimated future amount owed to customers in response to future returned goods. Estimated Inventory Returns will generally be added to the Inventory account at the end of the period.

Glossary Review

Comprehensive income
An income measure that includes gains and losses that are excluded from the determination of net income.

Comprehensive income statement
A statement that presents items that are not included in the determination of net income, referred to as other comprehensive income.

Contra revenue account
An account that is offset against a revenue account on the income statement.

Cost of goods sold
The total cost of merchandise sold during the period.

FOB destination
Freight terms indicating that the seller places the goods free on board to the buyer's place of business, and the seller pays the freight.

FOB shipping point
Freight terms indicating that the seller places goods free on board the carrier, and the buyer pays the freight costs.

Gross profit
The excess of net sales over the cost of goods sold.

Gross profit rate
Gross profit expressed as a percentage, by dividing the amount of gross profit by net sales.

Net sales
Sales revenue less sales returns and allowances and less sales discounts.

Operating expenses
Expenses incurred in the process of earning sales revenue.

Periodic inventory system
An inventory system under which the company does not keep detailed inventory records throughout the accounting period but determines the cost of goods sold only at the end of an accounting period.

Perpetual inventory system
An inventory system under which the company keeps detailed records of the cost of each inventory purchase and sale, and the records continuously show the inventory that should be on hand.

Purchase allowance
A deduction made to the selling price of merchandise, granted by the seller so that the buyer will keep the merchandise.

Purchase discount
A cash discount claimed by a buyer for prompt payment of a balance due.

Purchase invoice
A document that supports each credit purchase.

Purchase return
A return of goods from the buyer to the seller for a cash or credit refund.

Sales discount
A reduction given by a seller for prompt payment of a credit sale.

Sales invoice
A document that supports each credit sale.

Sales returns and allowances
Transactions in which the seller either accepts goods back from the purchaser (a return) or grants a reduction in the purchase price (an allowance) so that the buyer will keep the goods.

Sales revenue (Sales)
The primary source of revenue in a merchandising company.

Practice Multiple-Choice Questions

1. **(LO 1)** Gross profit will result if:

   a. operating expenses are less than net income.

   b. net sales are greater than operating expenses.

   c. net sales are greater than cost of goods sold.

   d. operating expenses are greater than cost of goods sold.

Solution

2. (LO 2) Under a perpetual inventory system, when goods are purchased for resale by a company:

a. purchases on account are debited to Inventory.

b. purchases on account are debited to Purchases.

c. purchase returns are debited to Purchase Returns and Allowances.

d. freight costs are debited to Freight-Out.

Solution

3. (LO 3) The sales accounts that normally have a debit balance are:

a. Sales Discounts.

b. Sales Returns and Allowances.

c. Both Sales Discounts, and Sales Returns and Allowances.

d. None of the answer choices is correct.

Solution

4. (LO 3) A credit sale of NT$7,500 is made on June 13, terms 2/10, net/30. A return of NT$500 is granted on June 16. The amount received as payment in full on June 23 is:

a. NT$7,000.

b. NT$6,860.

c. NT$6,850.

d. NT$6,500.

Solution

5. (LO 2) Which of the following accounts will normally appear in the ledger of a merchandising company that uses a perpetual inventory system?

a. Purchases.

b. Freight-In.

c. Cost of Goods Sold.

d. Purchase Discounts.

Solution

6. (LO 3) To record the sale of goods for cash in a perpetual inventory system:

a. only one journal entry is necessary to record cost of goods sold and reduction of inventory.

b. only one journal entry is necessary to record the receipt of cash and the sales revenue.

c. two journal entries are necessary: one to record the receipt of cash and sales revenue, and one to record the cost of goods sold and reduction of inventory.

d. two journal entries are necessary: one to record the receipt of cash and reduction of inventory, and one to record the cost of goods sold and sales revenue.

Solution

7. (LO 4) The steps in the accounting cycle for a merchandising company are the same as those in a service company **except**:

a. an additional adjusting journal entry for inventory may be needed in a merchandising company.

b. closing journal entries are not required for a merchandising company.

c. a post-closing trial balance is not required for a merchandising company.

d. an income statement is required for a merchandising company.

Solution

8. (LO 5) The income statement for a merchandising company shows each of the following features **except**:

a. gross profit.

b. cost of goods sold.

c. a sales section.

d. investing activities section.

Solution

9. **(LO 5)** If net sales are €400,000, cost of goods sold is €310,000, and operating expenses are €60,000, the gross profit is:

a. €30,000.

b. €90,000.

c. €340,000.

d. €400,000.

Solution

***10.** **(LO 6)** In a worksheet using a perpetual inventory system, Inventory is shown in the following columns:

a. adjusted trial balance debit and statement of financial position debit.

b. income statement debit and statement of financial position debit.

c. income statement credit and statement of financial position debit.

d. income statement credit and adjusted trial balance debit.

Solution

***11.** **(LO 7)** In determining cost of goods sold in a periodic system:

a. purchase discounts are deducted from net purchases.

b. freight-out is added to net purchases.

c. purchase returns and allowances are deducted from net purchases.

d. freight-in is added to net purchases.

Solution

***12.** **(LO 7)** If beginning inventory is HK$600,000, cost of goods purchased is HK$3,800,000, and ending inventory is HK$500,000, cost of goods sold is:

a. HK$3,900,000.

b. HK$3,700,000.

c. HK$3,300,000.

d. HK$4,200,000.

Solution

***13.** **(LO 7)** When goods are purchased for resale by a company using a periodic inventory system:

a. purchases on account are debited to Inventory.

b. purchases on account are debited to Purchases.

c. purchase returns are debited to Purchase Returns and Allowances.

d. freight costs are debited to Purchases.

Solution

Practice Brief Exercises

Compute the missing amounts in determining cost of goods sold.

1. **(LO 1)** Presented below are the components in determining cost of goods sold for (a) Frazier Hardware, (b) Todd Supplies, and (c) Abreu Beverages. Determine the missing amounts.

	Beginning Inventory	Purchases	Cost of Goods Available for Sale	Ending Inventory	Cost of Goods Sold
a.	£120,000	£150,000	?	?	£160,000
b.	£ 50,000	?	£125,000	£45,000	?
c.	?	£220,000	£330,000	£61,000	?

Solution

Journalize purchase transactions.

2. (LO 2) Prepare the journal entries to record the following transactions on Kowloon Group's books using a perpetual inventory system (amounts in thousands).

a. On March 2, Totoro Equipment sold ₩800,000 of merchandise to Kowloon, terms 2/10, n/30.

b. On March 6, Kowloon returned ₩100,000 of the merchandise purchased on March 2.

c. On March 12, Kowloon paid the balance due to Totoro.

Solution

Prepare closing entries.

3. (LO 4) Cabrera Enterprise has the following account balances: Sales Revenue €300,000, Sales Returns and Allowances €10,000, Cost of Goods Sold €174,000, and Inventory €50,000. Prepare the entries to record the closing of these items to Income Summary.

Solution

Compute net sales, gross profit, income from operations, and gross profit rate.

4. (LO 5) Assume Yoan Company has the following reported amounts: Sales revenue $400,000, Sales discounts $10,000, Cost of goods sold $234,000, and Operating expenses $60,000. Compute the following: (a) net sales, (b) gross profit, (c) income from operations, and (d) gross profit rate. (Round to one decimal place.)

Solution

Practice Exercises

Prepare purchase and sales entries.

1. (LO 2, 3) On June 10, Vareen Electronics purchased £8,000 of merchandise on account from Harrah Circuits, FOB shipping point, terms 3/10, n/30. Vareen pays the freight costs of £400 on June 11. Damaged goods totaling £300 are returned to Harrah for credit on June 12. The net realizable value of these goods is £70. On June 19, Vareen pays Harrah in full, less the purchase discount. Both companies use a perpetual inventory system.

Instructions

a. Prepare separate entries for each transaction on the books of Vareen Electronics.

b. Prepare separate entries for each transaction for Harrah Circuits. The merchandise purchased by Vareen on June 10 had cost Harrah £4,800.

Solution

Prepare an income statement.

2. (LO 5) In its income statement for the year ended December 31, 2025, Sun Ltd. reported the following condensed data.

Interest expense	NT$ 70,000	Net sales	NT$2,200,000
Operating expenses	725,000	Interest revenue	25,000
Cost of goods sold	1,300,000	Loss on disposal of plant assets	17,000

Instructions

Prepare an income statement.

Solution

Practice Problem

Prepare an income statement.

(LO 5) The adjusted trial balance columns of Falcetto SpA's worksheet for the year ended December 31, 2025, are as follows. (All amounts are in euros.)

	Debit		Credit
Cash	€ 14,500	Accumulated Depreciation—Equipment	€ 18,000
Accounts Receivable	11,100	Notes Payable	25,000
Inventory	29,000	Accounts Payable	10,600
Prepaid Insurance	2,500	Share Capital—Ordinary	70,000
Equipment	95,000	Retained Earnings	11,000
Dividends	12,000	Sales Revenue	536,800
Sales Returns and Allowances	6,700	Interest Revenue	2,500
Sales Discounts	5,000		
Cost of Goods Sold	363,400		
Freight-Out	7,600		
Advertising Expense	12,000		
Salaries and Wages Expense	56,000		
Utilities Expense	18,000		
Rent Expense	24,000		
Depreciation Expense	9,000		
Insurance Expense	4,500		
Interest Expense	3,600		
	€673,900		€673,900

Instructions

Prepare an income statement for Falcetto SpA.

Solution

Note: Asterisked Questions, Exercises, and Problems relate to material in the appendices to the chapter.

Questions

1. (a) "The steps in the accounting cycle for a merchandising company are different from the accounting cycle for a service company." Do you agree or disagree? (b) Is the measurement of net income for a merchandising company conceptually the same as for a service company? Explain.

2. Why is the normal operating cycle for a merchandising company likely to be longer than for a service company?

3. (a) How do the components of revenues and expenses differ between merchandising and service companies? (b) Explain the income measurement process in a merchandising company.

4. How does income measurement differ between a merchandising and a service company?

5. When is cost of goods sold determined in a perpetual inventory system?

6. Distinguish between FOB shipping point and FOB destination. Identify the freight terms that will result in a debit to Inventory by the buyer and a debit to Freight-Out by the seller.

7. Explain the meaning of the credit terms 2/10, n/30.

8. Goods costing £2,500 are purchased on account on July 15 with credit terms of 2/10, n/30. On July 18, a £200 credit memo is received from the supplier for damaged goods. Give the journal entry on July 24 to record payment of the balance due within the discount period using a perpetual inventory system.

9. Karen Lloyd believes revenues from credit sales may be recorded before they are collected in cash. Do you agree? Explain.

10. (a) What is the primary source document for recording (1) cash sales, (2) credit sales. (b) Using XXs for amounts, give the journal entry for each of the transactions in part (a).

11. A credit sale is made on July 10 for €700, terms 2/10, n/30. On July 12, €100 of goods are returned for credit. Give the journal entry on July 19 to record the receipt of the balance due within the discount period.

12. Explain why the Inventory account will usually require adjustment at year-end.

13. Prepare the closing entries for the Sales Revenue account, assuming a balance of €180,000 and the Cost of Goods Sold account with a €125,000 balance.

14. What merchandising account(s) will appear in the post-closing trial balance?

15. Regis Co. has net sales of HK$1,090,000, cost of goods sold of HK$700,000, and operating expenses of HK$230,000. What is its gross profit and its gross profit rate?

16. Kim Ho Company reports net sales of ¥800,000, gross profit of ¥570,000, and net income of ¥240,000. What are its operating expenses?

17. Identify the distinguishing features of an income statement for a merchandising company.

18. Identify the sections of an income statement that relate to (a) operating activities, and (b) non-operating activities.

***19.** Indicate the columns of the worksheet in which (a) inventory and (b) cost of goods sold will be shown using a perpetual inventory system.

***20.** Identify the accounts that are added to or deducted from Purchases to determine the cost of goods purchased using a periodic inventory system. For each account, indicate whether it is added or deducted.

***21.** Goods costing NT$60,000 are purchased on account on July 15 with credit terms of 2/10, n/30. On July 18, a NT$6,000 credit was received from the supplier for damaged goods. Give the journal entry on July 24 to record payment of the balance due within the discount period, assuming a periodic inventory system.

***22.** What are the steps to record an end of period adjustment for credit sales with returns and allowances?

***23.** What treatment do Refund Liability and Estimated Inventory Returns receive in the financial statements?

Brief Exercises

Compute missing amounts in determining net income.

BE5.1 (LO 1) Presented below are the components in Clearwater Pools' income statement. Determine the missing amounts.

	Sales Revenue	Cost of Goods Sold	Gross Profit	Operating Expenses	Net Income
a.	£78,000	?	£30,000	?	£10,800
b.	£108,000	£55,000	?	?	£29,500
c.	?	£83,900	£79,600	£39,500	?

Journalize perpetual inventory entries.

BE5.2 (LO 2, 3) Giovanni Leather Goods buys merchandise on account from Gordon Tannery. The selling price of the goods is €780, and the cost of the goods is €560. Both companies use perpetual inventory systems. Journalize the transaction on the books of both companies.

Journalize sales transactions.

BE5.3 (LO 3) Prepare the journal entries to record the following transactions on Benson Ltd.'s books using a perpetual inventory system.

a. On March 2, Benson sold £800,000 of merchandise on account to Edgebrook Company, terms 2/10, n/30. The cost of the merchandise sold was £620,000.

b. On March 6, Edgebrook returned £120,000 of the merchandise purchased on March 2. The cost of the returned merchandise was £90,000.

c. On March 12, Benson received the balance due from Edgebrook.

Journalize purchase transactions.

BE5.4 (LO 2) From the information in BE5.3, prepare the journal entries to record these transactions on Edgebrook Company's books under a perpetual inventory system.

Prepare adjusting entry for merchandise inventory.

BE5.5 (LO 4) At year-end, the perpetual inventory records of Federer Sports showed merchandise inventory of CHF98,000. The company determined, however, that its actual inventory on hand was CHF96,100. Record the necessary adjusting entry.

Prepare closing entries for accounts.

BE5.6 (LO 4) Orlaida Bath Salts has the following account balances: Sales Revenue €192,000, Sales Discounts €2,000, Cost of Goods Sold €105,000, and Inventory €40,000. Prepare the entries to record the closing of these items to Income Summary.

Prepare sales section of income statement.

BE5.7 (LO 5) Yangtze Canoes provides the following information for the month ended October 31, 2025 (amounts in Chinese yuan): sales on credit ¥280,000, cash sales ¥100,000, sales discounts ¥5,000, sales returns and allowances ¥22,000. Prepare the sales section of the income statement based on this information.

Explain presentation in an income statement.

BE5.8 (LO 5) Writing Explain where each of the following items would appear on an income statement: (a) gain on sale of equipment, (b) interest expense, (c) casualty loss from vandalism, (d) cost of goods sold, and (e) depreciation expense.

Compute net sales, gross profit, income from operations, and gross profit rate.

BE5.9 (LO 5) Assume Jose Foods has the following reported amounts: Sales revenue €506,000, Sales returns and allowances €13,000, Cost of goods sold €342,000, Operating expenses €110,000. Compute the following: (a) net sales, (b) gross profit, (c) income from operations, and (d) gross profit rate. (Round to one decimal place.)

Identify worksheet columns for selected accounts.

***BE5.10 (LO 6)** Presented below is the format of the worksheet presented in Appendix 5A.

Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Statement of Financial Position	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.

Indicate where the following items will appear on the worksheet: (a) Cash, (b) Inventory, (c) Sales revenue, and (d) Cost of goods sold.

Example:

Cash: Trial balance debit column; Adjusted trial balance debit column; and Statement of financial position debit column.

Compute net purchases and cost of goods purchased.

***BE5.11 (LO 7)** Assume that Kowloon Electronics uses a periodic inventory system and has these account balances (in thousands): Purchases ₩430,000; Purchase Returns and Allowances ₩13,000; Purchase Discounts ₩8,000; and Freight-In ₩16,000. Determine net purchases and cost of goods purchased.

Compute cost of goods sold and gross profit.

***BE5.12 (LO 7)** Assume the same information as in BE5.11 and also that Kowloon Electronics has beginning inventory (in thousands) of ₩60,000, ending inventory of ₩86,000, and net sales of ₩680,000. Determine the amounts to be reported for cost of goods sold and gross profit.

Journalize purchase transactions.

***BE5.13 (LO 7)** Prepare the journal entries to record these transactions on Huntington Kitchen's books using a periodic inventory system.

a. On March 2, Huntington purchased £900,000 of merchandise on account from Saunder Cabinets, terms 2/10, n/30.

b. On March 6, Huntington returned £184,000 of the merchandise purchased on March 2.

c. On March 12, Huntington paid the balance due to Saunder.

Prepare closing entries for merchandise accounts.

***BE5.14 (LO 7)** Hall Music has the following merchandise account balances: Sales Revenue $180,000, Sales Discounts $2,000, Purchases $120,000, and Purchases Returns and Allowances $30,000. In addition, it has a beginning inventory

of $40,000 and an ending inventory of $30,000. Prepare the entries to record the closing of these items to Income Summary using the periodic inventory system.

Identify worksheet columns for selected accounts.

***BE5.15 (LO 7)** Presented below is the format of the worksheet using the periodic inventory system presented in Appendix 5B.

Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Statement of Financial Position	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.

Indicate where the following items will appear on the worksheet: (a) Cash, (b) Beginning inventory, (c) Accounts payable, and (d) Ending inventory.

Example:

Cash: Trial balance debit column; Adjustment trial balance debit column; and Statement of financial position debit column.

Record entry for estimated sales returns.

***BE5.16 (LO 8)** At December 31, 2025, Famillа Company estimates that goods with a selling price of $1,400 and a cost of $650 that were sold on account during the current period will be returned during the next accounting period. Record the entry or entries required to adjust for this information.

DO IT! Exercises

Answer general questions about merchandisers.

DO IT! 5.1 (LO 1) Indicate whether the following statements are true or false. If false, indicate how to correct the statement.

1. A merchandising company reports gross profit but a service company does not.
2. Under a periodic inventory system, a company determines the cost of goods sold each time a sale occurs.
3. A service company is likely to use accounts receivable but a merchandising company is not likely to do so.
4. Under a periodic inventory system, the cost of goods on hand at the beginning of the accounting period plus the cost of goods purchased less the cost of goods on hand at the end of the accounting period equals cost of goods sold.

Record transactions of purchasing company.

DO IT! 5.2 (LO 2) On October 5, Lepik Flowers buys merchandise on account from Tamm Gardens. The selling price of the goods is €4,700, and the cost to Tamm is €3,100. On October 8, Lepik returns defective goods with a selling price of €650 and a net realizable value of €160. Record the transactions on the books of Lepik.

Record transactions of selling company.

DO IT! 5.3 (LO 3) Assume information similar to that in **DO IT! 5.2**. That is: On October 5, Lepik Flowers buys merchandise on account from Tamm Gardens. The selling price of the goods is €4,700, and the cost to Tamm is €3,100. On October 8, Lepik returns defective goods with a selling price of €650 and a net realizable value of €160. Record the transactions on the books of Tamm.

Prepare closing entries for a merchandising company.

DO IT! 5.4 (LO 4) The trial balance of Alagoas's Boutique at December 31 shows Inventory R$21,000, Sales Revenue R$156,000, Sales Returns and Allowances R$4,100, Sales Discounts R$3,000, Cost of Goods Sold R$92,400, Interest Revenue R$3,000, Freight-Out R$2,200, Utilities Expense R$7,400, and Salaries and Wages Expense R$19,500. Prepare the closing entries for Alagoas for these accounts.

Classify financial statement accounts.

DO IT! 5.5 (LO 5) Dorothea Publications is preparing its income statement, retained earnings statement, and classified statement of financial position. Using the column headings *Account, Financial Statement*, and *Classification*, indicate in which financial statement and under what classification each of the following would be reported.

Account	Financial Statement	Classification
Accounts Payable		
Accounts Receivable		
Accumulated Depreciation—Buildings		
Cash		
Casualty Loss from Vandalism		
Cost of Goods Sold		
Depreciation Expense		
Equipment		
Freight-Out		
Insurance Expense		
Interest Payable		
Inventory		
Land		
Notes Payable (due in 5 years)		
Share Capital—Ordinary		
Retained Earnings		
Dividends		
Property Taxes Payable		
Salaries and Wages Expense		
Salaries and Wages Payable		
Sales Returns and Allowances		
Sales Revenue		
Unearned Rent Revenue		
Utilities Expense		

Exercises

Answer general questions about merchandisers.

E5.1 (LO 1) Mr. Soukup has prepared the following list of statements about service companies and merchandisers.

1. Measuring net income for a merchandiser is conceptually the same as for a service company.
2. For a merchandiser, sales less operating expenses is called gross profit.
3. For a merchandiser, the primary source of revenues is the sale of inventory.
4. Sales salaries and wages is an example of an operating expense.
5. The operating cycle of a merchandiser is the same as that of a service company.
6. In a perpetual inventory system, no detailed inventory records of goods on hand are maintained.
7. In a periodic inventory system, the cost of goods sold is determined only at the end of the accounting period.
8. A periodic inventory system provides better control over inventories than a perpetual system.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Journalize purchase transactions.

E5.2 (LO 2) Information related to Duffy Yachts is presented below.

1. On April 5, purchased merchandise on account from Thomas Nautical Supply for £25,000, terms 2/10, net/30, FOB shipping point.
2. On April 6, paid freight costs of £900 on merchandise purchased from Thomas.
3. On April 7, purchased equipment on account for £26,000.
4. On April 8, returned damaged merchandise to Thomas and was granted a £2,600 credit for returned merchandise.
5. On April 15, paid the amount due to Thomas in full.

Instructions

a. Prepare the journal entries to record these transactions on the books of Duffy under a perpetual inventory system.

b. Assume that Duffy paid the balance due to Thomas on May 4 instead of April 15. Prepare the journal entry to record this payment.

Journalize perpetual inventory entries.

E5.3 (LO 2, 3) On September 1, Moreau Office Supply had an inventory of 30 calculators at a cost of €22 each. The company uses a perpetual inventory system. During September, the following transactions occurred.

Sept.	6	Purchased with cash 90 calculators at €20 each from Roux Electronics.
	9	Paid freight of €180 on calculators purchased from Roux.
	10	Returned 3 calculators to Roux for €66 cash (including freight) because they did not meet specifications.
	12	Sold 28 calculators costing €22 (including freight) for €33 each on account to Village Book Store, terms n/30.
	14	Granted credit of €33 to Village Book Store for the return of one calculator that was not ordered.
	20	Sold 40 calculators costing €22 for €35 each on account to Holiday Card Shop, terms n/30.

Instructions

Journalize the September transactions.

Prepare purchase and sales entries.

E5.4 (LO 2, 3) On June 10, York Gifts purchased £7,600 of merchandise from Bianchi Designs, FOB shipping point, terms 2/10, n/30. York pays the freight costs of £400 on June 11. Damaged goods totaling £300 are returned to Bianchi for credit on June 12. The net realizable value of these goods is £70. On June 19, York pays Bianchi in full, less the purchase discount. Both companies use a perpetual inventory system.

Instructions

a. Prepare separate entries for each transaction on the books of York.

b. Prepare separate entries for each transaction for Bianchi. The merchandise purchased by York on June 10 had cost Bianchi £4,300.

Journalize sales transactions.

E5.5 (LO 3) Presented below are transactions related to Li Gourmet.

1. On December 3, Li sold HK$580,000 of merchandise on account to South China Ltd. terms 1/10, n/30, FOB shipping point. The cost of the merchandise sold was HK$364,800.
2. On December 8, South China was granted an allowance of HK$28,000 for merchandise purchased on December 3.
3. On December 13, Li received the balance due from South China.

Instructions

a. Prepare the journal entries to record these transactions on the books of Li, using a perpetual inventory system.

b. Assume that Li received the balance due from South China on January 2 of the following year instead of December 13. Prepare the journal entry to record the receipt of payment on January 2.

Prepare sales section and closing entries.

E5.6 (LO 4, 5) The adjusted trial balance of Mendoza Auto Supply shows the following data pertaining to sales at the end of its fiscal year October 31, 2025: Sales Revenue €820,000, Freight-Out €16,000, Sales Returns and Allowances €28,000, and Sales Discounts €13,000.

Instructions

a. Prepare the sales section of the income statement.

b. Prepare separate closing entries for (1) sales, and (2) the contra accounts to sales.

Prepare adjusting and closing entries.

E5.7 (LO 4) Hezir Creations had the following account balances at year-end: Cost of Goods Sold Ł60,000, Inventory Ł15,000, Operating Expenses Ł29,000, Sales Revenue Ł117,000, Sales Discounts Ł1,300, and Sales Returns and Allowances Ł1,700. A physical count of inventory determines that merchandise inventory on hand Łis 14,200.

Instructions

a. Prepare the adjusting entry necessary as a result of the physical count.

b. Prepare closing entries.

Prepare adjusting and closing entries.

E5.8 (LO 4) Presented below is information related to Poulsen Industries for the month of January 2025.

Ending inventory per perpetual records	€ 21,600	Insurance expense	€ 12,000
Ending inventory actually on hand	21,000	Rent expense	20,000
Cost of goods sold	208,000	Salaries and wages expense	59,000
Freight-out	7,000	Sales discounts	8,000
		Sales returns and allowances	13,000
		Sales revenue	378,000

Instructions

a. Prepare the necessary adjusting entry for inventory.

b. Prepare the necessary closing entries.

Prepare an income statement.

E5.9 (LO 5) Presented below is information for Bach Chocolatiers for the month of March 2025.

Cost of goods sold	£212,000	Rent expense	£ 32,000
Freight-out	9,000	Sales discounts	7,400
Insurance expense	7,000	Sales returns and allowances	13,000
Salaries and wages expense	58,000	Sales revenue	380,000
		Other comprehensive income	2,200

Instructions

a. Prepare an income statement.

b. Prepare a comprehensive income statement.

c. Compute the gross profit rate.

Prepare an income statement.

E5.10 (LO 5) In its income statement for the year ended December 31, 2025, Mancini Films reported the following condensed data.

Operating expenses	€ 725,000	Interest revenue	€ 33,000
Cost of goods sold	1,256,000	Loss on disposal of plant assets	17,000
Interest expense	70,000	Net sales	2,200,000
		Other comprehensive income	8,300

Instructions

a. Prepare an income statement.

b. Prepare a comprehensive income statement.

Prepare correcting entries for sales and purchases.

E5.11 (LO 2, 3) An inexperienced accountant for Zoeng Ceramics made the following errors in recording merchandising transactions.

1. A HK$1,750 refund to a customer for faulty merchandise was debited to Sales Revenue HK$1,750 and credited to Cash HK$1,750.
2. A HK$1,400 credit purchase of supplies was debited to Inventory HK$1,400 and credited to Cash HK$1,400.
3. A HK$2,150 sales discount was debited to Sales Revenue.
4. A cash payment of HK$200 for freight on merchandise purchases was debited to Freight-Out HK$2,000 and credited to Cash HK$2,000.

Instructions

Prepare separate correcting entries for each error, assuming that the incorrect entry is not reversed. (Omit explanations.)

Compute various income measures.

E5.12 (LO 5) In 2025, Endeaver Cameras had net sales of £860,000 and cost of goods sold of £533,200. Operating expenses were £221,000, and interest expense was £7,000.

Instructions

a. Compute Endeaver's gross profit.

b. Compute the gross profit rate. Why is this rate computed by financial statement users?

c. What is Endeaver's income from operations and net income?

d. In what section of its classified statement of financial position should Endeaver report merchandise inventory?

Compute missing amounts and compute gross profit rate.

E5.13 (LO 5) Presented below is financial information for two different companies (amounts in thousands).

	Natasha Shoes	Boris Footwear
Sales revenue	руб94,000	(d)
Sales returns	(a)	руб 5,000
Net sales	80,000	98,000
Cost of goods sold	56,000	(e)
Gross profit	(b)	37,500
Operating expenses	12,000	(f)
Net income	(c)	15,000

Instructions

a. Determine the missing amounts.

b. Determine the gross profit rates. (Round to one decimal place.)

Compute missing amounts.

E5.14 (LO 5) Financial information is presented below for three different companies.

	Athena Cosmetics	Harry Grocery	Panama Wholesalers
Sales revenue	€90,000	€ (e)	€122,000
Sales returns and allowances	(a)	5,000	12,000
Net sales	86,000	95,000	(i)
Cost of goods sold	56,000	(f)	(j)
Gross profit	(b)	22,000	24,000
Operating expenses	15,000	(g)	18,000
Income from operations	(c)	(h)	(k)
Other income and expense	(4,000)	(3,000)	(l)
Net income	(d)	11,000	5,000

Instructions

Determine the missing amounts.

Complete worksheet for selected accounts.

***E5.15 (LO 6)** The following are selected accounts for Feisal Pet Supply as reported in the worksheet at the end of May 2025.

Accounts	Adjusted Trial Balance		Income Statement		Statement of Financial Position	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	9,000					
Inventory	76,000					
Sales Revenue		460,000				
Sales Returns and Allowances	10,000					
Sales Discounts	9,000					
Cost of Goods Sold	288,000					

Instructions

Complete the worksheet by extending amounts reported in the adjusted trial balance to the appropriate columns in the worksheet. Do not total individual columns.

Prepare a worksheet.

***E5.16 (LO 6)** The trial balance columns of the worksheet for Barbosa Apparel at June 30, 2025, are as follows.

Barbosa Apparel
Worksheet
For the Month Ended June 30, 2025

Account Titles	Trial Balance	
	Debit	**Credit**
Cash	2,120	
Accounts Receivable	2,740	
Inventory	11,640	
Accounts Payable		1,120
Share Capital—Ordinary		4,000
Sales Revenue		42,800
Cost of Goods Sold	20,560	
Operating Expenses	10,860	
	47,920	47,920

Other data:

Operating expenses incurred on account, but not yet recorded, total R$1,640.

Instructions

Enter the trial balance on a worksheet and complete the worksheet.

Prepare cost of goods sold section.

***E5.17 (LO 7)** The trial balance of Biju Medical Supplies at the end of its fiscal year, August 31, 2025, includes these accounts (amounts in thousands): Inventory Rp17,200; Purchases Rp149,000; Sales Revenue Rp190,000; Freight-In Rp5,000; Sales Returns and Allowances Rp3,000; Freight-Out Rp1,000; and Purchase Returns and Allowances Rp6,200. The ending inventory is Rp16,000.

Instructions

Prepare a cost of goods sold section for the year ending August 31 (periodic inventory).

Compute various income statement items.

***E5.18 (LO 7)** On January 1, 2025, Scott Enterprises has an inventory of £50,000. At December 31, 2025, Scott had the following account balances.

Freight-in	£ 4,000
Purchases	509,000
Purchase discounts	6,000
Purchase returns and allowances	8,000
Sales revenue	840,000
Sales discounts	7,000
Sales returns and allowances	11,000

At December 31, 2025, Scott determines that its ending inventory is £60,000.

Instructions

a. Compute Scott's 2025 gross profit.

b. Compute Scott's 2025 operating expenses if net income is £130,000 and there are no non-operating activities.

Compute missing amounts for cost of goods sold section.

***E5.19 (LO 7)** Below is a series of cost of goods sold sections for companies Alpha, Beta, Chi, and Decca.

	Alpha	Beta	Chi	Decca
Beginning inventory	€ 165	€ 70	€1,000	€ (j)
Purchases	1,620	1,060	(g)	43,810
Purchase returns and allowances	40	(d)	290	(k)
Net purchases	(a)	1,030	6,210	41,090
Freight-in	95	(e)	(h)	2,240
Cost of goods purchased	(b)	1,280	7,940	(l)
Cost of goods available for sale	1,840	1,350	(i)	49,530
Ending inventory	310	(f)	1,450	6,230
Cost of goods sold	(c)	1,260	7,490	43,300

Instructions

Fill in the lettered blanks to complete the cost of goods sold sections.

Journalize purchase transactions.

***E5.20 (LO 7)** This information relates to Olaf Decor.

1. On April 5, purchased merchandise on account from DeVito Group for €18,000, terms 2/10, net/30, FOB shipping point.
2. On April 6, paid freight costs of €820 on merchandise purchased from DeVito.
3. On April 7, purchased equipment on account for €30,000.
4. On April 8, returned some of April 5 merchandise, which cost €2,800, to DeVito.
5. On April 15, paid the amount due to DeVito in full.

Instructions

a. Prepare the journal entries to record these transactions on the books of Olaf using a periodic inventory system.

b. Assume that Olaf paid the balance due to DeVito on May 4 instead of April 15. Prepare the journal entry to record this payment.

Journalize purchase transactions.

***E5.21 (LO 7)** Presented below is information related to Chilean Industries.

1. On April 5, purchased merchandise on account from Graham Ltd. for £17,400, terms 2/10, net/30, FOB shipping point.
2. On April 6, paid freight costs of £800 on merchandise purchased from Graham.
3. On April 7, purchased equipment on account from Reed Manufacturing for £27,000.
4. On April 8, returned merchandise, which cost £4,000, to Graham.
5. On April 15, paid the amount due to Graham in full.

Instructions

a. Prepare the journal entries to record these transactions on the books of Chilean Industries using a periodic inventory system.

b. Assume that Chilean Industries paid the balance due to Graham on May 4 instead of April 15. Prepare the journal entry to record this payment.

Complete worksheet.

***E5.22 (LO 7)** Presented below are selected accounts for Midler Stores as reported in the worksheet at the end of May 2025. Ending inventory is $75,000.

Accounts	Adjusted Trial Balance		Income Statement		Statement of Financial Position	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	9,000					
Inventory	80,000					
Purchases	240,000					
Purchase Returns and Allowances		30,000				
Sales Revenue		450,000				
Sales Returns and Allowances	10,000					
Sales Discounts	5,000					
Rent Expense	42,000					

Instructions

Complete the worksheet by extending amounts reported in the adjusted trial balance to the appropriate columns in the worksheet. The company uses the periodic inventory system.

Record entry for estimated sales returns.

***E5.23 (LO 8), AP** At December 31, 2025, Highland Stores estimates that goods with a selling price of $4,700 and a cost of $1,870 that were sold on account during the current period will be returned during the next accounting period. On January 17, 2026, the goods were returned as estimated. The customer had not paid for the goods by the time of the return.

Instructions

Record the entry or entries required to adjust for this information, as well as the subsequent return.

Problems

Journalize purchase and sales transactions under a perpetual inventory system.

P5.1 (LO 2, 3) Ready-Set-Go distributes suitcases to retail stores and extends credit terms of 1/10, n/30 to all of its customers. At the end of June, Ready-Set-Go's inventory consisted of suitcases costing £1,200. During the month of July, the following merchandising transactions occurred.

July	1	Purchased suitcases on account for £1,620 from Trunk Manufacturers, FOB destination, terms 2/10, n/30. The appropriate party also made a cash payment of £100 for freight on this date.
	3	Sold suitcases on account to Satchel World for £2,200. The cost of suitcases sold was £1,400.
	9	Paid Trunk Manufacturers in full.
	12	Received payment in full from Satchel World.
	17	Sold suitcases on account to Lady GoGo for £1,400. The cost of the suitcases sold was £1,030.
	18	Purchased suitcases on account for £1,900 from Holiday Manufacturers, FOB shipping point, terms 1/10, n/30. The appropriate party also made a cash payment of £125 for freight on this date.
	20	Received £300 credit (including freight) for suitcases returned to Holiday Manufacturers.
	21	Received payment in full from Lady GoGo.
	22	Sold suitcases on account to Vagabond for £2,400. The cost of suitcases sold was £1,350.
	30	Paid Holiday Manufacturers in full.
	31	Granted Vagabond £200 credit for suitcases returned costing £120.

Ready-Set-Go's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Inventory, No. 201 Accounts Payable, No. 401 Sales Revenue, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, and No. 505 Cost of Goods Sold.

Instructions

Journalize the transactions for the month of July for Ready-Set-Go using a perpetual inventory system.

Journalize, post, and prepare a partial income statement.

P5.2 (LO 2, 3, 5) Vree Distributors completed the following merchandising transactions in the month of April. At the beginning of April, the ledger of Vree showed Cash of €8,000 and Share Capital—Ordinary of €8,000.

Apr.	2	Purchased merchandise on account from Walker Supply €6,200, terms 1/10, n/30.
	4	Sold merchandise on account €5,500, FOB destination, terms 1/10, n/30. The cost of the merchandise sold was €3,400.
	5	Paid €240 freight on April 4 sale.
	6	Received credit from Walker Supply for merchandise returned €500.
	11	Paid Walker Supply in full, less discount.
	13	Received collections in full, less discounts, from customers billed on April 4.
	14	Purchased merchandise for cash €3,800.
	16	Received refund from supplier for returned goods on cash purchase of April 14, €500.
	18	Purchased merchandise from Benjamin Glassware €4,500, FOB shipping point, terms 2/10, n/30.
	20	Paid freight on April 18 purchase €160.
	23	Sold merchandise for cash €7,400. The merchandise sold had a cost of €4,120.
	26	Purchased merchandise for cash €2,300.
	27	Paid Benjamin Glassware in full, less discount.
	29	Made refunds to cash customers for defective merchandise €90. The returned merchandise had a net realizable value of €30.
	30	Sold merchandise on account €3,400, terms n/30. The cost of the merchandise sold was €1,900.

Vree's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Inventory, No. 201 Accounts Payable, No. 311 Share Capital—Ordinary, No. 401 Sales Revenue, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 505 Cost of Goods Sold, and No. 644 Freight-Out.

Instructions

a. Journalize the transactions using a perpetual inventory system.

b. Enter the beginning cash and share capital—ordinary balances, and post the transactions. (Use J1 for the journal reference.)

c. Prepare the income statement through gross profit for the month of April 2025.

c. Gross profit €6,765

Prepare financial statements and adjusting and closing entries.

P5.3 (LO 4, 5) Starz Department Store is located near the Towne Shopping Mall. At the end of the company's calendar year on December 31, 2025, the following accounts appeared in two of its trial balances.

	Unadjusted	Adjusted
Accounts Payable	£ 76,300	£ 77,300
Accounts Receivable	50,300	50,300
Accumulated Depr.—Buildings	42,100	52,500
Accumulated Depr.—Equipment	29,600	42,700
Buildings	290,000	290,000
Cash	23,800	23,800
Cost of Goods Sold	412,700	412,700
Depreciation Expense		23,500
Dividends	24,000	24,000
Equipment	110,000	110,000
Insurance Expense		7,200
Interest Expense	3,000	8,100
Interest Payable		5,100
Interest Revenue	4,000	4,000

	Unadjusted	Adjusted
Inventory	£ 75,000	£ 75,000
Mortgage Payable	80,000	80,000
Prepaid Insurance	9,600	2,400
Property Tax Expense		4,800
Property Taxes Payable		4,800
Retained Earnings	64,600	64,600
Salaries and Wages Expense	105,000	105,000
Sales Commissions Expense	10,200	14,500
Sales Commissions Payable		4,300
Sales Returns and Allowances	8,000	8,000
Sales Revenue	724,000	724,000
Share Capital—Ordinary	112,000	112,000
Utilities Expense	11,000	12,000

Instructions

a. Prepare an income statement, a retained earnings statement, and a classified statement of financial position. £16,000 of the mortgage payable is due for payment next year.

a. Net income £132,200
Retained earnings £172,800
Total assets £456,300

b. Journalize the adjusting entries that were made.

c. Journalize the closing entries that are necessary.

Journalize, post, and prepare a trial balance.

P5.4 (LO 2, 3) J. Zheng, a former professional tennis star, operates Zheng's Tennis Shop at the Yalong River Resort. At the beginning of the current season, the ledger of Zheng's Tennis Shop showed Cash ¥2,200, Inventory ¥1,800, and Share Capital—Ordinary ¥4,000. The following transactions were completed during April.

Apr.	4	Purchased racquets and balls from Jay-Mac Ltd. ¥760, FOB shipping point, terms 2/10, n/30.
	6	Paid freight on purchase from Jay-Mac ¥40.
	8	Sold merchandise to members ¥1,150, terms n/30. The merchandise sold had a cost of ¥790.
	10	Received credit of ¥60 from Jay-Mac for a racquet that was returned.
	11	Purchased tennis shoes from Li Sports for cash, ¥420.
	13	Paid Jay-Mac in full.
	14	Purchased tennis shirts and shorts from Everett Sportswear ¥800, FOB shipping point, terms 3/10, n/60.
	15	Received cash refund of ¥50 from Li Sports for damaged merchandise that was returned.
	17	Paid freight on Everett Sportswear purchase ¥30.
	18	Sold merchandise to members ¥980, terms n/30. The cost of the merchandise sold was ¥520.
	20	Received ¥600 in cash from members in settlement of their accounts.
	21	Paid Everett Sportswear in full.
	27	Granted an allowance of ¥40 to members for tennis clothing that did not fit properly.
	30	Received cash payments on account from members, ¥820.

The chart of accounts for the tennis shop includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Inventory, No. 201 Accounts Payable, No. 311 Share Capital—Ordinary, No. 401 Sales Revenue, No. 412 Sales Returns and Allowances, and No. 505 Cost of Goods Sold.

Instructions

a. Journalize the April transactions using a perpetual inventory system.

b. Enter the beginning balances in the ledger accounts and post the April transactions. (Use J1 for the journal reference.)

c. Prepare a trial balance on April 30, 2025.

c. Total debits ¥6,130

Complete accounting cycle beginning with a worksheet.

***P5.5 (LO 4, 5, 6)** The trial balance of Rosiak Fashion Center contained the following accounts at November 30, the end of the company's fiscal year.

Rosiak Fashion Center Trial Balance November 30, 2025		
	Debit	**Credit**
Cash	£ 8,700	
Accounts Receivable	27,700	
Inventory	44,700	
Supplies	6,200	
Equipment	133,000	
Accumulated Depreciation—Equipment		£ 23,000
Notes Payable		51,000
Accounts Payable		48,500
Share Capital—Ordinary		50,000
Retained Earnings		38,000
Dividends	8,000	
Sales Revenue		755,200
Sales Returns and Allowances	12,800	
Cost of Goods Sold	497,400	
Salaries and Wages Expense	136,000	
Advertising Expense	24,400	
Utilities Expense	14,000	
Maintenance and Repairs Expense	12,100	
Freight-Out	16,700	
Rent Expense	24,000	
Totals	£965,700	£965,700

Adjustment data:

1. Supplies on hand totaled £2,100.
2. Depreciation is £11,500 on the equipment.
3. Interest of £4,000 is accrued on notes payable at November 30.
4. Inventory actually on hand is £44,520.

Instructions

a. Enter the trial balance on a worksheet, and complete the worksheet.

a. Adj. trial balance £981,200
Net loss £1,980

b. Journalize the adjusting entries.

c. Prepare an income statement and a retained earnings statement for the year, and a classified statement of financial position as of November 30, 2025. Notes payable of £6,000 are due in January 2026.

c. Gross profit £244,820
Total assets £181,520

d. Journalize the closing entries.

e. Prepare a post-closing trial balance.

Determine cost of goods sold and gross profit under periodic approach.

***P5.6 (LO 7)** At the end of Hotai Department Store's fiscal year on December 31, 2025, these accounts appeared in its adjusted trial balance.

Freight-In	NT$ 165,000
Inventory	1,215,000
Purchases	13,200,000
Purchase Discounts	360,000
Purchase Returns and Allowances	192,000
Sales Revenue	21,540,000
Sales Returns and Allowances	510,000

Additional facts:

1. Merchandise inventory on December 31, 2025, is NT$1,950,000.
2. Hotai Department Store uses a periodic system.

Instructions

Prepare an income statement through gross profit for the year ended December 31, 2025.

Gross profit NT$8,952,000

Calculate missing amounts and assess profitability.

***P5.7 (LO 7)** Writing Fons Apparel, a retail clothing operation, purchases all merchandise inventory on credit and uses a periodic inventory system. The Accounts Payable account is used for recording inventory purchases only; all other current liabilities are accrued in separate accounts. You are provided with the following selected information for the fiscal years 2022 through 2025, inclusive.

	2022	2023	2024	2025
Inventory (ending)	€13,000	€ 11,300	€ 14,700	€ 12,200
Accounts payable (ending)	20,000			
Sales revenue		225,700	240,300	235,000
Purchases of merchandise inventory on account		141,000	150,000	132,000
Cash payments to suppliers		135,000	161,000	127,000

Instructions

a. Calculate cost of goods sold for each of the 2023, 2024, and 2025 fiscal years.

a. 2024 €146,600

b. Calculate the gross profit for each of the 2023, 2024, and 2025 fiscal years.

c. Calculate the ending balance of accounts payable for each of the 2023, 2024, and 2025 fiscal years.

c. 2024 Ending accts. payable €15,000

d. Sales declined in fiscal 2025. Does that mean that profitability, as measured by the gross profit rate, necessarily also declined? Explain, calculating the gross profit rate for each fiscal year to help support your answer. (Round to one decimal place.)

Journalize, post, and prepare trial balance and partial income statement using periodic approach.

***P5.8 (LO 7)** At the beginning of the current season, the ledger of Village Tennis Shop showed Cash CHF2,500, Inventory CHF1,700, and Share Capital—Ordinary CHF4,200. The following transactions were completed during April.

Apr.	4	Purchased racquets and balls from Hingis AG CHF860, terms 3/10, n/30.
	6	Paid freight on Hingis purchase CHF74.
	8	Sold merchandise to members CHF900, terms n/30.
	10	Received credit of CHF60 from Hingis for a racquet that was returned.
	11	Purchased tennis shoes from Volker Sports for cash CHF300.
	13	Paid Hingis in full.
	14	Purchased tennis shirts and shorts from Linzey Sportswear CHF700, terms 2/10, n/60.
	15	Received cash refund of CHF90 from Volker Sports for damaged merchandise that was returned.
	17	Paid freight on Linzey Sportswear purchase CHF25.
	18	Sold merchandise to members CHF1,200, terms n/30.
	20	Received CHF500 in cash from members in settlement of their accounts.
	21	Paid Linzey Sportswear in full.
	27	Granted an allowance of CHF25 to members for tennis clothing that did not fit properly.
	30	Received cash payments on account from members CHF630.

The chart of accounts for the tennis shop includes Cash, Accounts Receivable, Inventory, Accounts Payable, Share Capital—Ordinary, Sales Revenue, Sales Returns and Allowances, Purchases, Purchase Returns and Allowances, Purchase Discounts, and Freight-In.

Instructions

a. Journalize the April transactions using a periodic inventory system.

b. Using T-accounts, enter the beginning balances in the ledger accounts and post the April transactions.

c. Prepare a trial balance on April 30, 2025.

c. Tot. trial balance CHF6,488

d. Prepare an income statement through gross profit, assuming inventory on hand at April 30 is CHF2,140.

d. Gross profit CHF744

Comprehensive Accounting Cycle Review

ACR5 On December 1, 2025, Jurczyk Distributing had the following account balances.

	Debit		Credit
Cash	€ 7,200	Accumulated Depreciation—Equipment	€ 2,200
Accounts Receivable	4,600	Accounts Payable	4,500
Inventory	12,000	Salaries and Wages Payable	1,000
Supplies	1,200	Share Capital—Ordinary	30,000
Equipment	22,000	Retained Earnings	9,300
	€47,000		€47,000

During December, the company completed the following summary transactions.

Dec.	6	Paid €1,600 for salaries and wages due employees, of which €600 is for December and €1,000 is for November salaries and wages payable.
	8	Received €2,100 cash from customers in payment of account (no discount allowed).
	10	Sold merchandise for cash €6,600. The cost of the merchandise sold was €4,100.
	13	Purchased merchandise on account from Gong Co. €9,000, terms 2/10, n/30.
	15	Purchased supplies for cash €2,000.
	18	Sold merchandise on account €12,000, terms 3/10, n/30. The cost of the merchandise sold was €8,400.
	20	Paid salaries and wages €1,800.
	23	Paid Gong Co. in full, less discount.
	27	Received collections in full, less discounts, from customers billed on December 18.

Adjustment data:

1. Accrued salaries and wages payable €800.
2. Depreciation €200 per month.

3. Supplies on hand €1,700.

Instructions

a. Journalize the December transactions using a perpetual inventory system.

b. Enter the December 1 balances in the ledger T-accounts and post the December transactions. Use Cost of Goods Sold, Depreciation Expense, Salaries and Wages Expense, Sales Revenue, Sales Discounts, and Supplies Expense.

c. Journalize and post adjusting entries.

d. Prepare an adjusted trial balance.

d. Totals €65,600

e. Prepare an income statement and a retained earnings statement for December and a classified statement of financial position at December 31.

e. Net income €840

Data Analytics in Action

Using Data Visualization to Analyze Profitability Changes over Time

DA5.1 Data visualization can be used to understand profitability trends.

Example Even with the arrival of the global pandemic in 2020, **REI** (USA) continues to be a strong competitor in the outdoor gear industry. The pandemic, however, added to the shift in what, where, and when consumers buy. For example, more customers now buy online as some stores were temporarily closed. So how is REI doing? We can use the following column chart to visualize the company's performance.

The chart illustrates REI's profitability from 2016 to 2020. We can see that REI's sales increased steadily for the first four years, with the largest dollar increase from 2018 to 2019. The pandemic caused a decline in sales as expected during 2020. Because gross profit is tied to sales, the company's gross profit resulted in a gradual increase as sales increased through 2019, with an expected drop in 2020. The slope of the trend lines shows that the sales increased at a greater rate than gross profit for the first four years, implying that cost of goods sold was increasing faster than sales. Despite the promising increase in gross profit through 2019, REI's net profit margin remained flat through 2019, indicating operating expenses must have been increasing.

For this case, you will use data from five years of REI's income statements to compute the percentage of net sales for each item on the income statements, prepare a clustered column chart by year to visualize each of the four subtotal percentages computed, and evaluate what the chart tells you about trends in sales and expenses. Because REI is a co-op in which members share in the company's profits, note that the company recognizes these distributions as expenses on its income statements.

Go to the Wiley online course for complete case details and instructions.

Using Data Visualization to Compare Companies' Profitability

DA5.2 **Caterpillar** (USA) is a manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines, and diesel-electric locomotives. **Cummins** (USA) is a company that designs, manufactures, sells, and services diesel and natural gas engines and powertrain-related component products. **CNH Industrial** (USA) operates in the capital goods sector and designs, produces, and sells agricultural and construction equipment, trucks, commercial vehicles, buses, and specialty vehicles.

For this case, you will use financial information from these three companies to consider the implications if they each reuse existing materials. This action can reduce their cost of goods sold, which should cause their gross margin to increase. You will compute the gross profit ratio, as well as percentages of cost of goods sold, other expenses, and net income as compared to revenue, for the three companies. You will also prepare a clustered column chart by company showing cost of goods sold, other expenses, and net operating income as a percent of sales revenue, to compare the three companies. Finally, you will research their sustainability reports and consider in what ways Caterpillar, Cummins, and CNH Industrial promote rebuilding and recycling, and what impact recycling has on the companies' profitability.

Go to the Wiley online course for complete case details and instructions.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT5.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

Answer the following questions using TSMC's consolidated income statement.

a. What was the percentage change in (1) sales (net revenue) and in (2) net income from 2019 to 2020?

b. What was the company's gross profit rate in 2019 and 2020?

c. What was the company's percentage of net income to net sales in 2019 and 2020? Comment on any trend in this percentage.

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT5.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information contained in these financial statements, determine each of the following for each company.

1. Gross profit for the most recent fiscal year reported in the appendices.
2. Gross profit rate for the most recent fiscal year reported in the appendices.
3. Operating income for the most recent fiscal year reported in the appendices. (*Note:* Operating income may be described with alternative labels.)
4. Percentage change in operating income for the most recent fiscal year reported in the appendices.

b. What conclusions concerning the relative profitability of the two companies can you draw from these data?

Real-World Focus

CT5.3 No financial decision-maker should ever rely solely on the financial information reported in the annual report to make decisions. It is important to keep abreast of financial news. This activity demonstrates how to search for financial news on the Internet.

Instructions

Search the Internet for a financial-news article about **Nestlé** (CHE) or **Delfi Limited** (SGP) that sounds interesting to you and then answer the following questions.

a. What was the source of the article (e.g., Reuters, Businesswire, PR Newswire)?

b. Assume that you are a personal financial planner and that one of your clients owns shares in the company. Write a brief email to your client, summarizing the article and explaining the implications of the article for this investment.

Decision-Making Across the Organization

CT5.4 Three years ago, Debbie Sells and her brother-in-law Mike Mooney opened Family Department Store. For the first two years, business was good, but the following condensed income results for 2024 were disappointing.

Family Department Store Income Statement For the Year Ended December 31, 2024		
Net sales		£700,000
Cost of goods sold		553,000
Gross profit		147,000
Operating expenses		
Selling expenses	£100,000	
Administrative expenses	20,000	120,000
Net income		£ 27,000

Debbie believes the problem lies in the relatively low gross profit rate (gross profit divided by net sales) of 21%. Mike believes the problem is that operating expenses are too high.

Debbie thinks the gross profit rate can be improved by making both of the following changes. She does not anticipate that these changes will have any effect on operating expenses.

1. Increase average selling prices by 20%. This increase is expected to lower sales volume so that total sales will increase only 5%.
2. Buy merchandise in larger quantities and take all purchase discounts. These changes to selling and purchasing practices are expected to increase the gross profit rate from 21% to 24%.

Mike thinks expenses can be cut by making both of the following changes. He feels that these changes will not have any effect on net sales.

1. Cut 2025 sales salaries (selling expenses) of £60,000 in half and give sales personnel a commission of 2% of net sales.
2. Reduce store deliveries to one day per week rather than twice a week; this change will reduce 2025 delivery expenses (selling expenses) of £30,000 by 40%.

Debbie and Mike come to you for help in deciding the best way to improve net income.

Instructions

With the class divided into groups, answer the following.

a. Prepare a condensed income statement for 2025, assuming (1) Debbie's changes are implemented and (2) Mike's ideas are adopted.

b. What is your recommendation to Debbie and Mike?

c. Prepare a condensed income statement for 2025, assuming both sets of proposed changes are made.

Communication Activity

CT5.5 The following situation is in chronological order.

1. Dexter decides to buy a surfboard.
2. He calls Boardin Co. to inquire about its surfboards.
3. Two days later, he requests Boardin Co. to make a surfboard.
4. Three days later, Boardin Co. sends Dexter a purchase order to fill out.
5. He sends back the purchase order.
6. Boardin Co. receives the completed purchase order.
7. Boardin Co. completes the surfboard.
8. Dexter picks up the surfboard.
9. Boardin Co. bills Dexter.
10. Boardin Co. receives payment from Dexter.

Instructions

In an email to the president of Boardin Co., answer the following.

a. When should Boardin Co. record the sale?

b. Suppose that with his purchase order, Dexter is required to make a down payment. Would that change your answer?

Ethics Case

CT5.6 Anita Zurbrugg was just hired as the assistant treasurer of Yorktown Stores. The company is a specialty chain store with nine retail stores concentrated in one metropolitan area. Among other things, the payment of all invoices is centralized in one of the departments Anita will manage. Her primary responsibility is to maintain the company's high credit rating by paying all bills when due and to take advantage of all cash discounts.

Chris Dadian, the former assistant treasurer who has been promoted to treasurer, is training Anita in her new duties. He instructs Anita that she is to continue the practice of preparing all checks "net of discount" and dating the checks the last day of the discount period. "But," Chris continues, "we always hold the checks at least 4 days beyond the discount period before mailing them. That way, we get another 4 days of interest on our money. Most of our creditors need our business and don't complain. And, if they scream about our missing the discount period, we blame it on the mailroom or the post office. We've only lost one discount out of every hundred we take that way. I think everybody does it. By the way, welcome to our team!"

Instructions

a. What are the ethical considerations in this case?

b. Who are the stakeholders that are harmed or benefitted in this situation?

c. Should Anita continue the practice started by Chris? Does she have any choice?

A Look at U.S. GAAP

LEARNING OBJECTIVE 9

Compare the accounting for merchandising under IFRS and U.S. GAAP.

The basic accounting entries for merchandising are the same under both GAAP and IFRS. The income statement is a required statement under both sets of standards. The basic format is similar although some differences do exist.

Key Points

IAS 1, "Presentation of Financial Statements," provides general guidelines for the reporting of income statement information. Subsequently, a number of international standards have been issued that provide additional guidance to issues related to income statement presentation. The following is a recent income statement for **Walmart Inc.** (USA). The income statement is presented in conformity with GAAP.



Walmart Inc.
Income Statement

(Amounts in millions except per share data)	
Revenues:	
Net sales	$473,076
Membership and other income	3,218
	476,294
Costs and expenses:	
Cost of sales	358,069
Operating, selling, general and administrative expenses	91,353
Operating income	26,872
Interest:	
Debt	2,072
Capital leases	263
Interest income	(119)
Interest, net	2,216
Income from continuing operations before income taxes	24,656
Provision for income taxes:	
Current	8,619
Deferred	(514)
	8,105
Income from continuing operations	16,551
Income (loss) from discontinued operations, net of tax	144
Consolidated net income	16,695
Less consolidated net income attributable to noncontrolling interest	(673)
Consolidated net income attributable to Walmart	$ 16,022

Similarities

- Under both GAAP and IFRS, a company can choose to use either a perpetual or a periodic system.
- Inventories are defined by IFRS as held-for-sale in the ordinary course of business, in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the performing of services. The definition under GAAP is essentially the same.
- Similar to GAAP, comprehensive income under IFRS includes unrealized gains and losses (such as those on non-trading securities) that are not included in the calculation of net income.

Differences

- Under GAAP, companies generally classify income statement items by function. Classification by function leads to descriptions like administration, distribution (selling), and manufacturing. Under IFRS, companies may classify

expenses by either nature or by function. Classification by nature leads to descriptions such as the following: salaries, depreciation expense, and utilities expense. If a company uses the functional-expense method on the income statement, disclosure by nature is required in the notes to the financial statements.

- Presentation of the income statement under GAAP follows either a single-step or multiple-step format. IFRS does not mention a single-step or multiple-step approach.
- Under IFRS, revaluation of land, buildings, and intangible assets is permitted. The initial gains and losses resulting from this revaluation are reported as adjustments to equity, often referred to as **other comprehensive income**. The effect of this difference is that the use of IFRS instead of GAAP results in more transactions affecting equity (other comprehensive income) but not net income.
- IFRS requires that two years of income statement information be presented, whereas GAAP has no similar requirement. However, public companies following U.S. Securities and Exchange Commission regulations are required to present three-year comparative income statements.

GAAP Practice

GAAP Self-Test Questions

1. Which of the following would **not** be included in the definition of inventory under GAAP?

a. Photocopy paper held for sale by an office supply store.

b. Stereo equipment held for sale by an electronics store.

c. Used office equipment held for sale by the human relations department of a plastics company.

d. All of the answer choices would meet the definition.

Answer

2. Which of the following would **not** be a line item of a company reporting costs by nature?

a. Depreciation expense.

b. Salaries and wages expense.

c. Interest expense.

d. Manufacturing expense

Answer

3. Which of the following would **not** be a line item of a company reporting costs by function?

a. Administration.

b. Manufacturing.

c. Utilities expense.

d. Distribution.

Answer

4. Which of the following statements is **false**?

a. GAAP specifically requires use of a multiple-step income statement.

b. Under GAAP, companies can use either a perpetual or periodic system.

c. IFRS does not specify a single-step or multiple-step approach.

d. IFRS requires that 2 years of income statement information be presented.

Answer

5. Which of the following statements is **true**?

a. IFRS does not permit the reporting of expenses classified by nature.

b. Under both GAAP and IFRS, a company can choose to use either a perpetual or a periodic system.

c. GAAP treats all items held for sale as inventory, regardless of whether they are held of sale in the ordinary course of business or not.

d. GAAP permits the revaluation of property, plant, and equipment, whereas IFRS does not permit revaluation.

Answer

GAAP Exercises

GAAP5.1 Explain the difference between the "nature-of-expense" and "function-of-expense" classifications.

GAAP5.2 For each of the following income statement line items, state whether the item is a "by nature" expense item or a "by function" expense item.

_____ Cost of goods sold.
_____ Depreciation expense.
_____ Salaries and wages expense.
_____ Selling expenses.
_____ Utilities expense.
_____ Delivery expense.
_____ General and administrative expenses.

GAAP5.3 Atlantis Company reported the following amounts in 2025: net income, $150,000; unrealized gain related to revaluation of buildings, $10,000; and unrealized loss on non-trading securities, $(35,000). Determine Atlantis's total comprehensive income for 2025.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP5.4 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

(Round to one decimal place.)

a. What was the percentage change in (1) total revenue (net sales) and in (2) net income from 2018 to 2019 and from 2019 to 2020?

b. What was the company's gross profit margin rate in 2018, 2019, and 2020?

c. What was the company's percentage of net income to total revenue in 2018, 2019, and 2020?

Note

1 The "Anatomy of a Fraud" stories in this text are adapted from *Fraud Casebook: Lessons from the Bad Side of Business,* edited by Joseph T. Wells (Hoboken, NJ: John Wiley & Sons, Inc., 2007). Used by permission. The names of some of the people and organizations in the stories are fictitious, but the facts in the stories are true.

CHAPTER 7
Fraud, Internal Control, and Cash



Monkey Business Images/Shutterstock

Chapter Preview

As the following Feature Story about recording cash sales at **Nick's Steakhouse and Pizza** (CAN) indicates, control of cash is important to ensure that fraud does not occur. Companies also need controls to safeguard other types of assets. For example, Nick's undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of tableware and dishes from its kitchen.

In this chapter, we explain the essential features of an internal control system and how it prevents fraud. We also describe how those controls apply to a specific asset—cash. The applications include some controls with which you may be already familiar, such as the use of a bank.

Feature Story

Minding the Money at Nick's

Nick Petros, the founder of **Nick's Steakhouse and Pizza** (CAN) in Calgary, came to Canada from Greece at age 17 with no money and speaking no English. For 25 years, he worked his way up the ranks in the restaurant industry, as a dishwasher, busboy, waiter, maître d', and then manager. In 1979, he combined his industry experience with a collection of his mother's homemade recipes to open his own restaurant. Nick's son Mark took over the business in 2000.

Over the course of a busy Friday or Saturday evening, up to 11 servers and three bartenders serve as many as 1,200 people in the 650-square-meter restaurant and bar. Mark Petros says his point-of-sale (POS) system helps him keep track of the orders, inventory, and money.

After taking a table's order, servers enter the items they require into one of six computer terminals located throughout the restaurant. The computer is preprogrammed with the item and its price so that the server simply presses a labelled button, for example, "Caesar salad" or "lasagna," to enter an order. The POS system sends the order information to the bar, salad station, or line cooks, and uses the information to track inventory. The servers collect payment from their tables. At the end of a shift, the POS system provides an employee report that itemizes the credit card, debit card, and cash sales that the server generated.

The bartenders and servers have a cash float of $400. The hosting staff also has a float to use for pickup orders and in case the servers need change for large bills. Mr. Petros explains, "When an employee with a float starts the shift, he or she makes sure that the cash on hand is equal to the float plus any orders taken so far that day. At the end of their shift, the same calculation is done to see if it balances out, or else they are responsible for the missing money."

Similarly, before the bartenders start their shift, they have to count the beer in the fridges and note the levels in partially full bottles of alcohol. Everything must correspond to the POS system. For example, if three beers are missing from the fridge, three beers should have been entered in the system. If they weren't, the bartender is responsible.

"There's never a discrepancy," says Mr. Petros. If there ever is one, he adds, it's easy to find the problem, usually an error in pushing a button or entering information.

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Define fraud and the principles of internal control.	• Fraud • Internal control • Principles of internal control activities • Data analytics and internal controls • Limitations of internal control	DO IT! 1 Control Activities
LO 2 Apply internal control principles to cash.	• Cash receipts controls • Cash disbursements controls • Petty cash fund	DO IT! 2a Control over Cash Receipts 2b Petty Cash Fund
LO 3 Identify the control features of a bank account.	• Making bank deposits • Writing checks • Electronic banking • Bank statements • Reconciling the bank account	DO IT! 3 Bank Reconciliation
LO 4 Explain the reporting of cash.	• Cash equivalents • Restricted cash	DO IT! 4 Reporting Cash

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions. Additional tutorials and practice opportunities are available in the Wiley online course.

7.1 Fraud and Internal Control

> **LEARNING OBJECTIVE 1**
>
> Define fraud and the principles of internal control.

The Feature Story describes many of the internal control procedures used by **Nick's Steakhouse and Pizza** (CAN). These procedures are necessary to discourage employees from fraudulent activities.

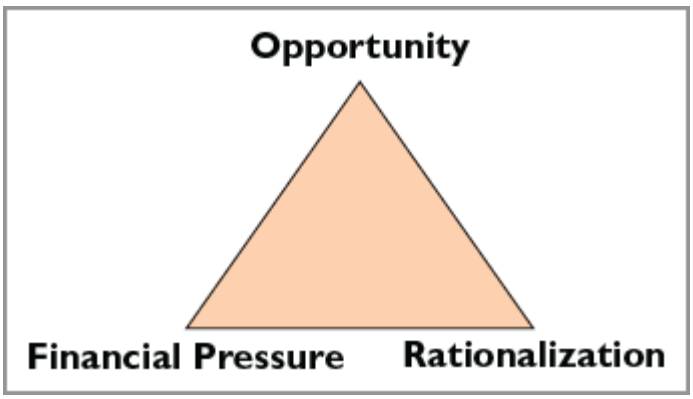
Fraud

A **fraud** is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. Examples of fraud reported in the financial press include the following.

- A bookkeeper in a small company diverted €750,000 of bill payments to a personal bank account over a three-year period.
- A shipping clerk with 28 years of service shipped $125,000 of merchandise to himself.
- A computer operator embezzled $21 million from **Wells Fargo Bank** (USA) over a two-year period.
- Drivers for a large Chinese ride-sharing service defrauded the company by partnering with customers who booked fake rides and then shared the driver's bonus received from the company for distances driven.

Why does fraud occur? The three main factors that contribute to fraudulent activity are depicted by the **fraud triangle** in **Illustration 7.1**.

ILLUSTRATION 7.1 Fraud triangle



1. **Opportunity**. Opportunities to engage in fraud occur when the workplace lacks sufficient controls to deter and detect fraud. For example, inadequate monitoring of employee actions can create opportunities for theft and can embolden employees because they believe they will not be caught.
2. **Financial pressure**. Employees sometimes commit fraud because of personal financial problems caused by too much debt. Or, they might commit fraud because they want to lead a lifestyle that they cannot afford on their current salary.
3. **Rationalization**. In order to justify their fraud, employees rationalize their dishonest actions. For example, employees sometimes justify fraud because they believe they are underpaid while the employer is making lots of money. Employees feel justified in stealing because they believe they deserve to be paid more.

Internal Control

Internal control is a process designed to provide reasonable assurance regarding the achievement of company objectives related to operations, reporting, and compliance. In more

detail, the purposes of internal control are to safeguard assets, enhance the reliability of accounting records, increase efficiency of operations, and ensure compliance with laws and regulations. Internal control systems have five primary components as listed below.[1]

1. **A control environment.** It is the responsibility of top management to make it clear that the organization values integrity and that unethical activity will not be tolerated. This component is often referred to as the "tone at the top."
2. **Risk assessment.** Companies must identify and analyze the various factors that create risk for the business and must determine how to manage these risks.
3. **Control activities.** To reduce the occurrence of fraud, management must design policies and procedures to address the specific risks faced by the company.
4. **Information and communication.** The internal control system must capture and communicate all pertinent information both down and up the organization, as well as communicate information to appropriate external parties.
5. **Monitoring.** Internal control systems must be monitored periodically for their adequacy. Significant deficiencies need to be reported to top management and/or the board of directors.

Environmental, Social, and Governance Insight

And the Controls Are …



BeholdingEye/Getty Images

Internal controls are important for an effective financial reporting system. The same is true for sustainability reporting. An effective system of internal controls for sustainability reporting will help in the following ways: (1) prevent the unauthorized use of data; (2) provide reasonable assurance that the information is accurate, valid, and complete; and (3) report information that is consistent with overall sustainability accounting policies. With these types of controls, users will have the confidence that they can use the sustainability information effectively.

Some regulators are calling for even more assurance through audits of this information. Companies that potentially can cause environmental damage through greenhouse gases, as well as companies in the mining and extractive industries, are subject to reporting requirements. And, as demand for more information in the sustainability area expands, the need for audits of this information will grow.

Why is sustainability information important to investors?

Answer

Principles of Internal Control Activities

Each of the five components of an internal control system is important. Here, we will focus on one component, the control activities. The reason? These activities are the backbone of the company's efforts to address the risks it faces, such as fraud. The specific control activities used by a company will vary, depending on management's assessment of the risks faced. This assessment is heavily influenced by the size and nature of the company.

The six principles of control activities are as follows.

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical controls
- Independent internal verification
- Human resource controls

We explain these principles in the following sections. You should recognize that they apply to most companies and are relevant to both manual and computerized accounting systems.

Establishment of Responsibility

An essential principle of internal control is to assign responsibility to specific employees. **Control is most effective when only one person is responsible for a given task.**

To illustrate, assume that the cash on hand at the end of the day in an **e-mart** (KOR) supermarket is ₩100 short of the cash entered in the cash register. If only one person has operated the register, the shift manager can quickly determine responsibility for the shortage. If two or more individuals have worked the register, it may be impossible to determine who is responsible for the error.

Many retailers solve this problem by having registers with multiple drawers. This makes it possible for more than one person to operate a register but still allows identification of a particular employee with a specific drawer. Only the signed-in cashier has access to his or her drawer.

Establishing responsibility often requires limiting access only to authorized personnel, and then identifying those personnel. For example, the automated systems used by many companies have mechanisms such as identifying passcodes that keep track of who made a journal entry, who entered a sale, or who went into an inventory storeroom at a particular time. Use of identifying passcodes enables the company to establish responsibility by identifying the particular employee who carried out the activity.



Anatomy of a Fraud

Maureen Frugali was a training supervisor for claims processing at Colossal Healthcare. As a standard part of the claims-processing training program, Maureen created fictitious claims for use by trainees. These fictitious claims were then sent to the accounts payable department.

After the training claims had been processed, Maureen was to notify Accounts Payable of all fictitious claims, so that they would not be paid. However, she did not inform Accounts Payable about every fictitious claim. She created some fictitious claims for entities that she controlled (that is, she would receive the payment), and she let Accounts Payable pay her.

Total take: $11 million

The Missing Control

Establishment of responsibility. The healthcare company did not adequately restrict the responsibility for authorizing and approving claims transactions. The training supervisor should not have been authorized to create claims in the company's "live" system.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 61–70.

Segregation of Duties

Segregation of duties is indispensable in an internal control system. There are two common applications of this principle:

1. Different individuals should be responsible for related activities.
2. The responsibility for recordkeeping for an asset should be separate from the physical custody of that asset.

The rationale for segregation of duties is this: **The work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee.** For example, the personnel that design and program computerized systems should not be assigned duties related to day-to-day use of the system. Otherwise, they could design the system to benefit them personally and conceal the fraud through day-to-day use.

Segregation of Related Activities

Making one individual responsible for related activities increases the potential for errors and irregularities.

Purchasing Activities

Companies should, for example, assign related **purchasing activities** to different individuals. Related purchasing activities include ordering merchandise, approving orders, receiving goods, authorizing payment, and paying for goods or services. Various frauds are possible when one person handles related purchasing activities:

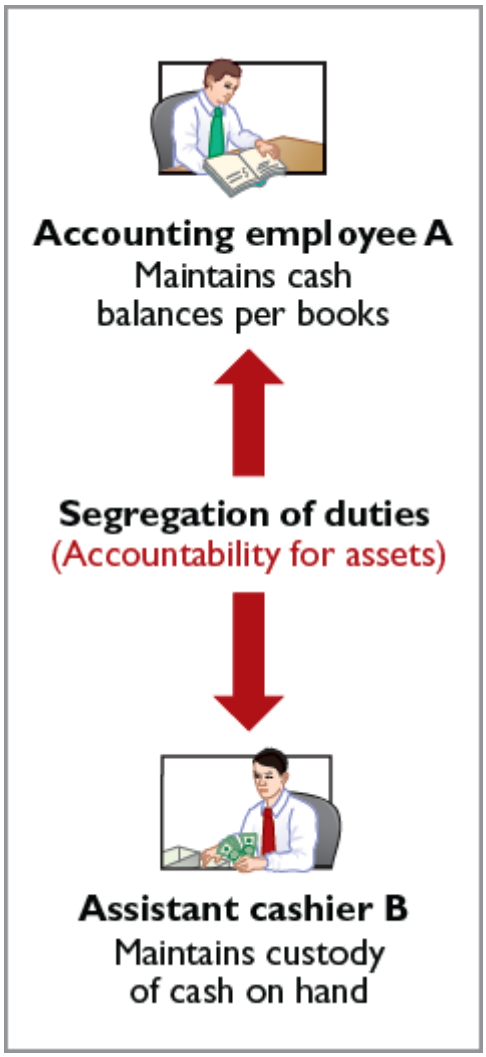
- If a purchasing agent is allowed to order goods without obtaining supervisory approval, the likelihood of the purchasing agent receiving kickbacks from suppliers increases.
- If an employee who orders goods also handles the invoice and receipt of the goods, as well as payment authorization, he or she might authorize payment for a fictitious invoice.

These abuses are less likely to occur when companies divide the purchasing tasks.

Sales Activities

Similarly, companies should assign related **sales activities** to different individuals. Related selling activities include making a sale, shipping (or delivering) the goods to the customer, billing the customer, and receiving payment. Various frauds are possible when one person handles related sales activities:

- If a salesperson can make a sale without obtaining supervisory approval, he or she might make sales at unauthorized prices to increase sales commissions.
- A shipping clerk who also has access to accounting records could ship goods to himself.
- A billing clerk who handles billing and receipt could understate the amount billed for sales made to friends and relatives.



These abuses are less likely to occur when companies divide the sales tasks. The salespeople make the sale, the shipping department ships the goods on the basis of the sales order, and the billing department prepares the sales invoice after comparing the sales order with the report of goods shipped.

Anatomy of a Fraud

Ronald Lee was the owner of an aluminum casting business in Malaysia. After several years of successful operations, he began incurring extravagant expenditures for travel and other luxury items. In order to fund his new lifestyle, Ronald began to steal money from his own company. The scam was committed by the company making payments for aluminum ingots that were never received by the company.

The payments for the fraudulent orders were made by the company's controllers with full knowledge that they were not actual shipments received, which allowed the fraud to avoid being detected by the company's auditors. The payments were made to a company owned by Mr. Lee's cousin. The checks were made out to Cash, which allowed Mr. Lee to deposit them directly into his own account.

The fraud was discovered when an outside investor hired a forensic accountant to investigate the large losses being incurred by the company.

Total take: RM20,757,500

The Missing Control

Segregation of duties. While it is common for the controller to prepare and authorize checks, this person should not be responsible to reconcile the bank account. During the reconciliation it is possible that questions could be raised about large checks made out to cash.

Source: Adapted from Wells, *Fraud Casebook* (2011), pp. 265–272.

Segregation of Recordkeeping from Physical Custody

The accountant should have neither physical custody of the asset nor access to it. Likewise, the custodian of the asset should not maintain or have access to the accounting records. **The custodian of the asset is not likely to convert the asset to personal use when one employee maintains the record of the asset, and a different employee has physical custody of the asset.** The separation of accounting responsibility from the custody of assets is especially important for cash and inventories because these assets are very vulnerable to fraud.

Anatomy of a Fraud

In some countries, it is common for a company to own its own bank. This bank loans money to its employees, collecting payments directly from the employees' paychecks. Such an arrangement was in place in Kenya when three executives decided to take advantage of the structure.

These executives began to make loans to themselves and also to members of the company's board. To cover their tracks, the executives prepared false entries on the records of the bank.

Total take: KSh1,669,500

The Missing Control

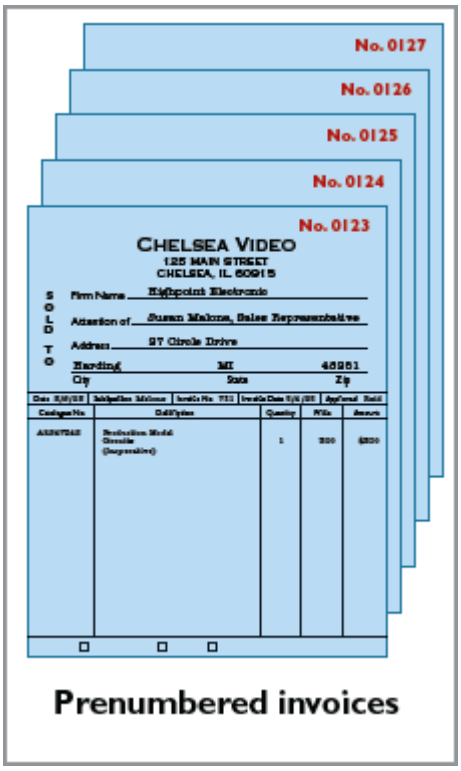
Segregation of duties. It is critical that the authorization, recordkeeping, and custody of assets stay separated. In this case, since the executives had both the authority to approve loans and also were responsible to keep the records for the bank, they were able to conceal their fraudulent behavior.

Source: Adapted from Wells, *Fraud Casebook* (2011), pp. 177–185.

Documentation Procedures

Documents provide evidence that transactions and events have occurred. For example, point-of-sale terminals are networked with a company's computing and accounting records, which results in direct documentation.

Similarly, a shipping document indicates that the goods have been shipped, and a sales invoice indicates that the company has billed the customer for the goods. By requiring signatures (or initials) on the documents, the company can identify the individual(s) responsible for the transaction or event. Companies should document transactions when they occur.



Prenumbered invoices

Companies should establish two procedures for documents.

1. Whenever possible, companies should use **prenumbered documents, and all documents should be accounted for**. Prenumbering helps to prevent a transaction from being recorded more than once, or conversely, from not being recorded at all.
2. The control system should require that employees **promptly forward source documents for accounting entries to the accounting department**. **This control measure helps to ensure timely recording of the transaction** and contributes directly to the accuracy and reliability of the accounting records.

Anatomy of a Fraud

To support their reimbursement requests for travel costs incurred, employees at Mod Fashions' design center were required to submit receipts. The receipts could include the detailed bill provided for a meal, the credit card receipt provided when the credit card payment is made, or a copy of the employee's monthly credit card bill that listed the item.

A number of the designers who frequently traveled together came up with a fraud scheme: They submitted claims for the same expenses. For example, if they had a meal together that cost €200, one person submitted the detailed meal bill, another submitted the credit card receipt, and a third submitted a monthly credit card bill showing the meal as a line item. Thus, all three received a €200 reimbursement.

Total take: €75,000

The Missing Control

Documentation procedures. Mod Fashions should require the original, detailed receipt. It should not accept photocopies, and it should not accept credit card statements. In addition, documentation procedures could be further improved by requiring the use of a company credit card (rather than a personal credit card) for all business expenses.

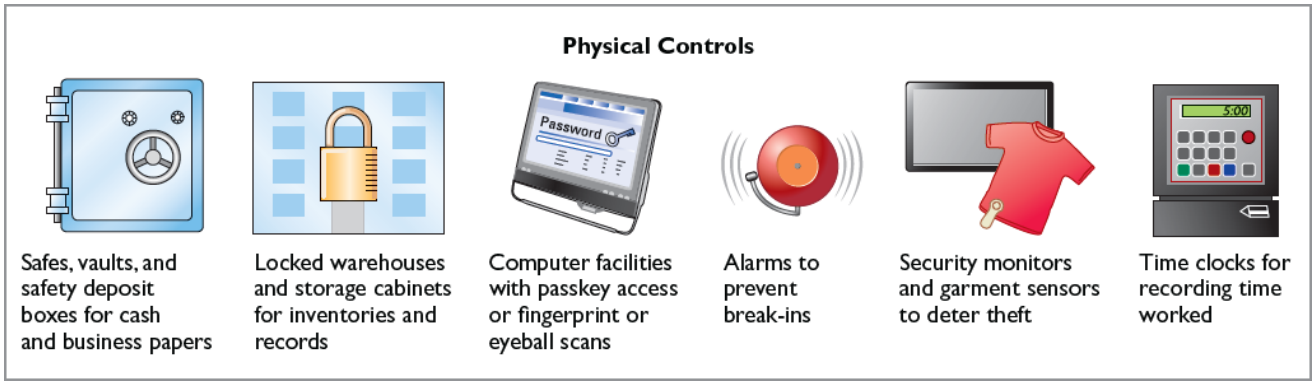
Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 79–90.

Physical Controls

Use of physical controls is essential. **Physical controls** relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records. Illustration 7.2 shows examples of

these controls.

ILLUSTRATION 7.2 Physical controls



Anatomy of a Fraud

At Centerstone Health, a large insurance company, the mailroom each day received insurance applications from prospective customers. Mailroom employees scanned the applications into electronic documents before the applications were processed. Once the applications were scanned, they could be accessed online by authorized employees.

Insurance agents at Centerstone Health earn commissions based upon successful applications. The sales agent's name is listed on the application. However, roughly 15% of the applications are from customers who did not work with a sales agent. Two friends—Alex, an employee in recordkeeping, and Parviz, a sales agent—thought up a way to perpetrate a fraud. Alex identified scanned applications that did not list a sales agent. After business hours, he entered the mailroom and found the hard-copy applications that did not show a sales agent. He wrote in Parviz's name as the sales agent and then rescanned the application for processing. Parviz received the commission, which the friends then split.

Total take: £240,000

The Missing Control

Physical controls. Centerstone Health lacked two basic physical controls that could have prevented this fraud. First, the mailroom should have been locked during non-business hours, and access during business hours should have been tightly controlled. Second, the scanned applications supposedly could be accessed only by authorized employees using their passwords. However, the password for each employee was the same as the employee's user ID. Since employee user-ID numbers were available to all other employees, all employees knew each other's passwords. Thus, Alex could enter the system using another employee's password and access the scanned applications.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 316–326.

Independent Internal Verification

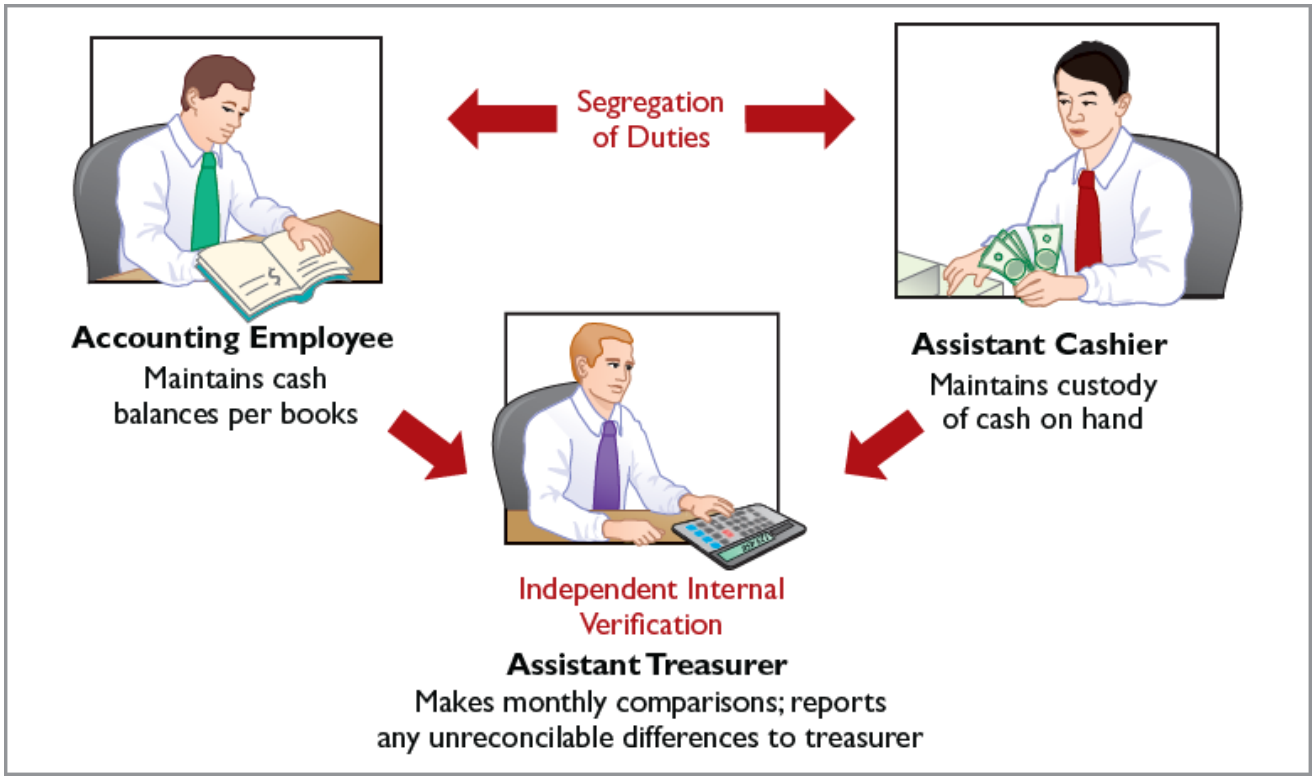
Most internal control systems provide for **independent internal verification**. This principle involves the review of data prepared by employees. To obtain maximum benefit from independent internal verification:

1. Companies should verify records periodically or on a surprise basis.
2. An employee who is independent of the personnel responsible for the information should make the verification.
3. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.

Independent internal verification is especially useful in comparing recorded accountability with existing assets. The reconciliation of the electronic journal with the cash in the point-of-sale

terminal at **Nick's Steakhouse and Pizza** is an example of this internal control principle. Other common examples are the reconciliation of a company's cash balance per books with the cash balance per bank, and the verification of the perpetual inventory records through a count of physical inventory. **Illustration 7.3** shows the relationship between this principle and the segregation of duties principle.

ILLUSTRATION 7.3 Comparison of segregation of duties principle with independent internal verification principle



Anatomy of a Fraud

Bobbi Donnelly, the office manager for Mod Fashions' design center, was responsible for preparing the design center budget and reviewing expense reports submitted by design center employees. Her desire to upgrade her wardrobe got the better of her, and she enacted a fraud that involved filing expense-reimbursement requests for her own personal clothing purchases.

Bobbi was able to conceal the fraud because she was responsible for reviewing all expense reports, including her own. In addition, she sometimes was given ultimate responsibility for signing off on the expense reports when her boss was "too busy." Also, because she controlled the budget, when she submitted her expenses, she coded them to budget items that she knew were running under budget, so that they would not catch anyone's attention.

Total take: €275,000

The Missing Control

Independent internal verification. Bobbi's boss should have verified her expense reports. When asked what he thought her expenses for a year were, the boss said about €10,000. At €115,000 per year, her actual expenses were more than 10 times what would have been expected. However, because he was "too busy" to verify her expense reports or to review the budget, he never noticed.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 79–90.

Large companies often assign independent internal verification to internal auditors. **Internal auditors** are company employees who continuously evaluate the effectiveness of the company's internal control systems. They review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements

when needed. For example, **WorldCom** (USA) was at one time the second largest U.S. telecommunications company. The fraud that caused its bankruptcy (the largest ever when it occurred) involved billions of dollars. It was uncovered by an internal auditor.

Human Resource Controls

Human resource control activities include the following.

1. **Bond employees who handle cash.** Bonding involves obtaining insurance protection against theft by employees. It contributes to the safeguarding of cash in two ways. First, the insurance company carefully screens all individuals before adding them to the policy and may reject risky applicants. Second, bonded employees know that the insurance company will vigorously prosecute all offenders.
2. **Rotate employees' duties and require employees to take vacations.** These measures deter employees from attempting thefts since they will not be able to permanently conceal their improper actions. Many banks, for example, have discovered employee thefts when the employee was on vacation or assigned to a new position.
3. **Conduct thorough background checks.** Many believe that the most important and inexpensive measure any business can take to reduce employee theft and fraud is for the human resource department to conduct thorough background checks. Two tips: (1) Check to see whether job applicants actually graduated from the schools they list. (2) Never use telephone numbers for previous employers provided by the applicant. Always look them up yourself.



Anatomy of a Fraud

Ellen Lowry was the desk manager and Josephine Rodriguez was the head of housekeeping at the Excelsior Inn, a luxury hotel. The two best friends were so dedicated to their jobs that they never took vacations, and they frequently filled in for other employees. In fact, Josephine, whose job as head of housekeeping did not include cleaning rooms, often cleaned rooms herself, "just to help the staff keep up."

These two "dedicated" employees, working as a team, found a way to earn a little more cash. Ellen, the desk manager, provided significant discounts to guests who paid with cash. She kept the cash and did not register the guests in the hotel's computerized system. Instead, she took the room out of circulation "due to routine maintenance." Because the room did not show up as being used, it did not receive a normal housekeeping assignment. Instead, Josephine, the head of housekeeping, cleaned the rooms during the guests' stay.

Total take: $95,000

The Missing Control

Human resource controls. Ellen, the desk manager, had been fired by a previous employer after being accused of fraud. If the Excelsior Inn had conducted a thorough background check, it would not have hired her. The hotel fraud was detected when Ellen missed work for a few days due to illness. A system of mandatory vacations and rotating days off would have increased the chances of detecting the fraud before it became so large.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 145–155.

Accounting Across the Organization



Stockbyte/Getty Images,

Internal Control and the Role of Human Resources

Companies need to keep track of employees' degrees and certifications to ensure that employees continue to meet the specified requirements of a job. Also, to ensure proper employee supervision and proper separation of duties, companies must develop and monitor an organizational chart.

When one company went through this exercise, it found that out of 17,000 employees, there were 400 people who did not report to anyone. The company also had 35 people who reported to each other. In addition, if an employee complains of an unfair firing and mentions financial issues at the company, the human resource department must refer the case to the company audit committee and possibly to its legal counsel.

Why would unsupervised employees or employees who report to each other represent potential internal control threats?

Answer

Data Analytics and Internal Controls

Data analytics has dramatically changed many aspects of internal control practices. In the past, internal and external auditors tended to rely heavily on investigations of period-end samples of transactions to identify potential violations. Now, rather than wait for a period-end sample, many companies employ continuous monitoring of virtually every transaction. As a result, spikes in certain types of activity or developing trends are more quickly identified and investigated.

- **Many different aspects of journal entries can be monitored continuously.** For example, systems can automatically identify who recorded a particular journal entry. This helps to ensure that the segregation of duties control principle is not violated.
- **Large dollar amounts in risky areas can also be flagged and investigated quickly.** Recipients of payments can be easily screened to ensure, for example, that bonus amounts are correctly determined based on results and bonus formulas, and that bonuses are only paid to employees who are designated for bonus payments.

Limitations of Internal Control

Companies generally design their systems of internal control to provide **reasonable assurance** of proper safeguarding of assets and reliability of the accounting records. The concept of reasonable assurance rests on the premise that the costs of establishing control procedures should not exceed their expected benefit (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Controls may vary with the risk level of the activity. For example, management may consider cash to be high risk and maintaining inventories in the stockroom as low risk. Thus, management would have stricter controls for cash.**

To illustrate, consider shoplifting losses in retail stores. Stores could eliminate such losses by having a security guard stop and search customers as they leave the store. But store managers have concluded that the negative effects of such a procedure cannot be justified. Instead, they have attempted to control shoplifting losses by less costly procedures. They post signs saying, "We reserve the right to inspect all packages" and "All shoplifters will be prosecuted." They use hidden cameras and store detectives to monitor customer activity, and they install sensor equipment at exits.

No system of internal control is perfect. Generally, two major limitations are inherent in internal control systems.

1. **The human element**. A good system can become ineffective as a result of employee fatigue, carelessness, or indifference. For example, a receiving clerk may not bother to count goods received and may just "fudge" the counts. Occasionally, two or more individuals may work together to get around prescribed controls. Such **collusion** can significantly reduce the effectiveness of a system, eliminating the protection offered by segregation of duties. No system of internal control is perfect.
2. **The size of the business**. Small companies often find it difficult to segregate duties or to provide for independent internal verification.

DO IT! 1

Control Activities

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

1. The person with primary responsibility for reconciling the bank account and making all bank deposits is also the company's accountant.
2. Wellstone Company's treasurer received an award for distinguished service because he had not taken a vacation in 30 years.
3. In order to save money spent on order slips and to reduce time spent keeping track of order slips, a local bar/restaurant does not buy prenumbered order slips.

ACTION PLAN

- **Familiarize yourself with each of the control activities.**
- **Understand the nature of the frauds that each control activity is intended to address.**

Solution

Related exercise material: **BE7.1**, **BE7.2**, **BE7.3**, **BE7.4**, **DO IT! 7.1**, **E7.1**, **E7.2**, **E7.3**, **E7.5**, **and** **E7.6**.

7.2 Cash Controls

LEARNING OBJECTIVE 2

Apply internal control principles to cash.

Cash is the one asset that is readily convertible into any other type of asset. It also is easily concealed and transported, and is highly desired.

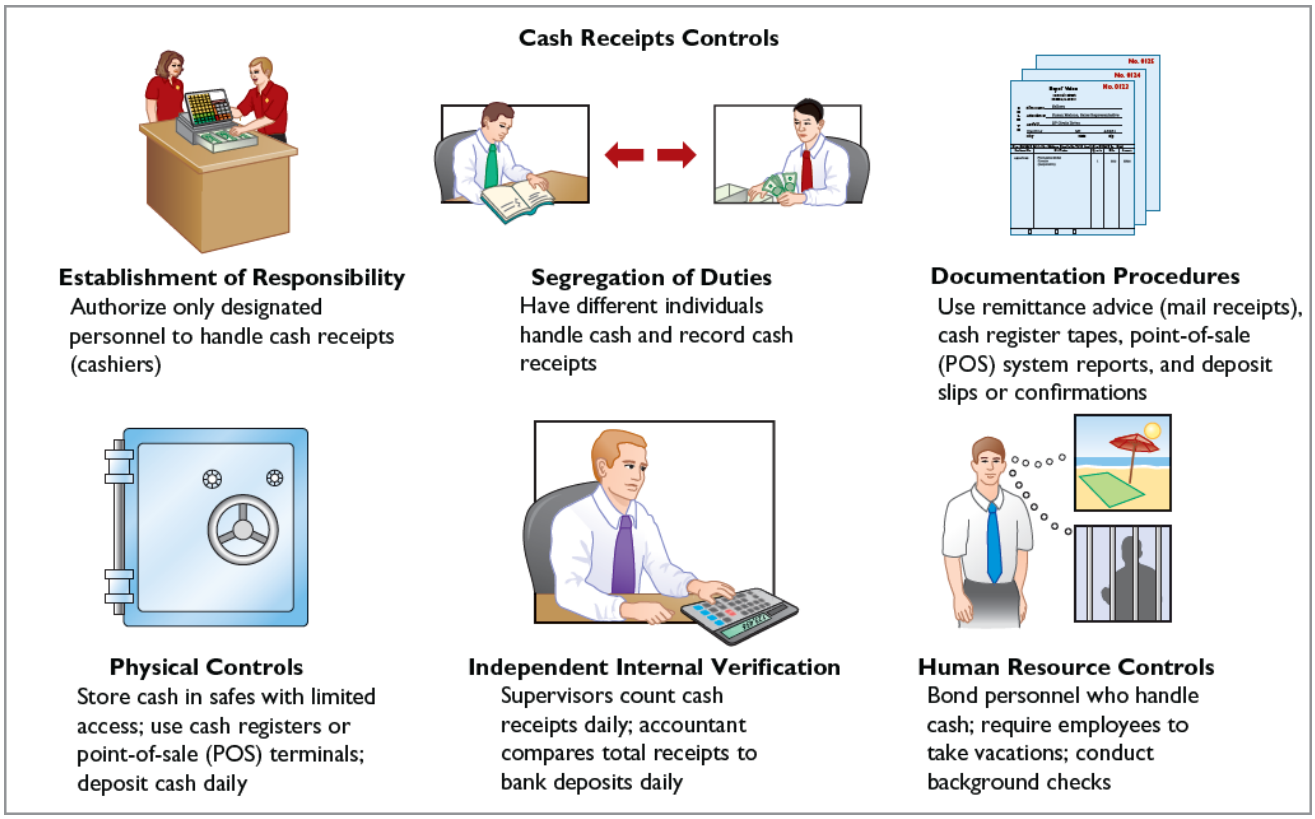
- Because of these characteristics, **cash is the asset most susceptible to fraudulent activities**.
- In addition, because of the large volume of cash transactions, numerous errors may occur in executing and recording them.

To safeguard cash and to ensure the accuracy of the accounting records for cash, effective internal control over cash is critical.

Cash Receipts Controls

Illustration 7.4 shows how the internal control principles explained earlier apply to cash receipts transactions. As you might expect, companies vary considerably in how they apply these principles. To illustrate internal control over cash receipts, we will examine control activities for a retail store with both over-the-counter and electronic and check receipts.

ILLUSTRATION 7.4 Application of internal control principles to cash receipts



Over-the-Counter Receipts

In retail businesses, control of over-the-counter receipts centers on cash registers. With the increase in cloud-based computing, point-of-sale (POS) cash register systems have become affordable even for most small businesses. Most retail businesses receive payment with cash, credit cards, or debit cards. Staff members who operate cash registers (physical control) are each given cash, called "float" (assignment of responsibility) to make change for customers who pay cash. All sales must be entered into the register through the POS software, which records the sale (documentation) at the proper price, often simply by scanning a bar code.

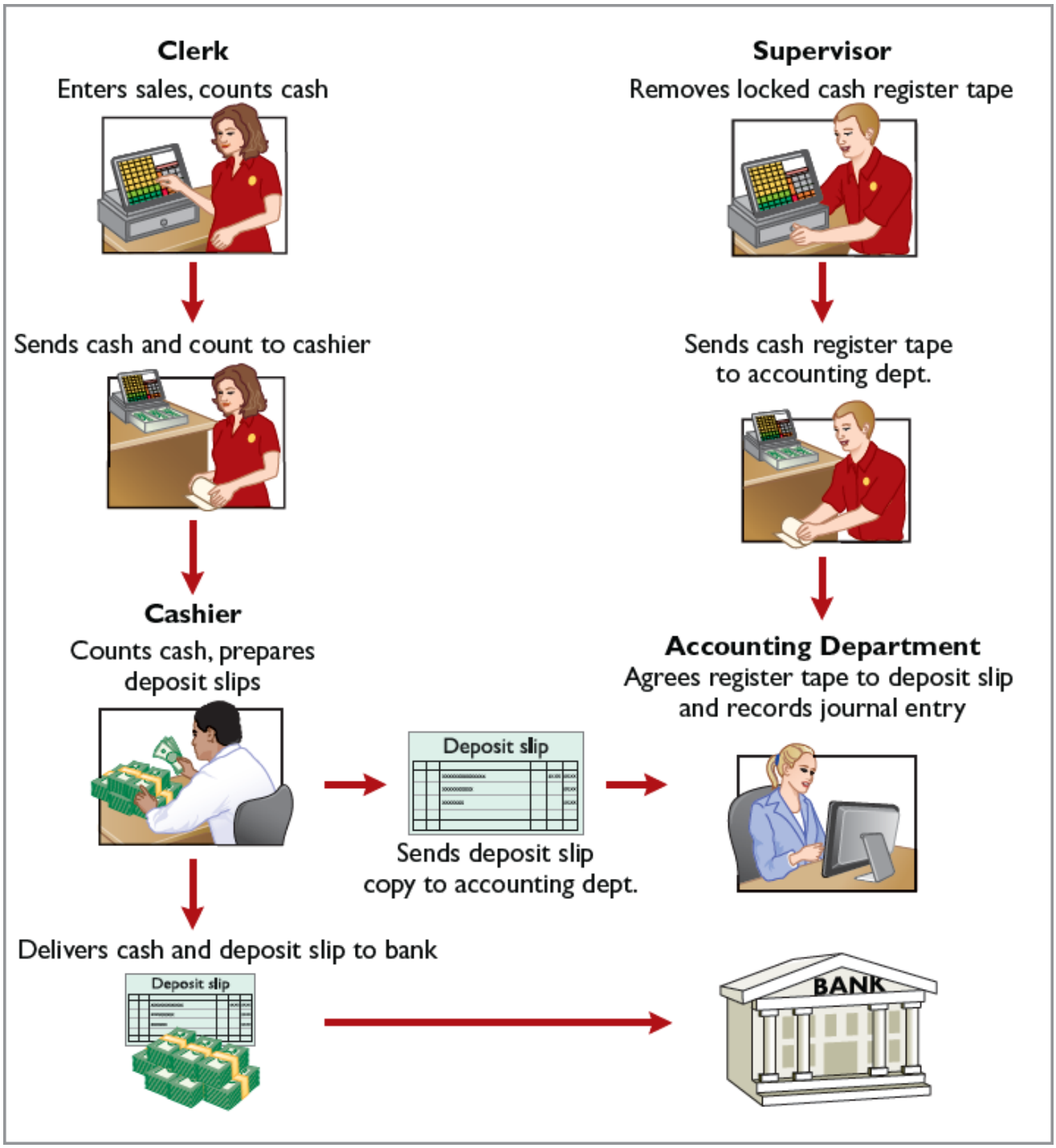
- A big advantage of POS systems is that they update inventory records at the time of sale if the company is using a perpetual inventory system.
- This increases the company's ability to decrease employee theft by frequently reconciling inventory records with the actual amount of inventory on shelves.

At the end of a shift, staff members count the cash to ensure it agrees with the amount reported in the system, and then they report the count to a supervisor. A supervisor double-checks the amount (independent internal verification) and then prepares a deposit slip.

Access to the system should be restricted (physical control) so that cashiers cannot adjust the amount and type of sales recorded at the register to understate reported sales. Without these controls, the cashiers could hide the fact that they have taken cash. Employees must also ensure that the receipts are on-hand for sales made by debit or credit cards and that these match sales that were recorded with this type of payment. (For point-of-sale systems, the accounting department receives information on daily transactions and totals through the computer network.) Illustration 7.5 summarizes this process (see Helpful Hint).

> **HELPFUL HINT**
>
> **Flowcharts such as this one enhance the understanding of the flow of documents, the processing steps, and the internal control procedures.**

ILLUSTRATION 7.5 Control of over-the-counter receipts



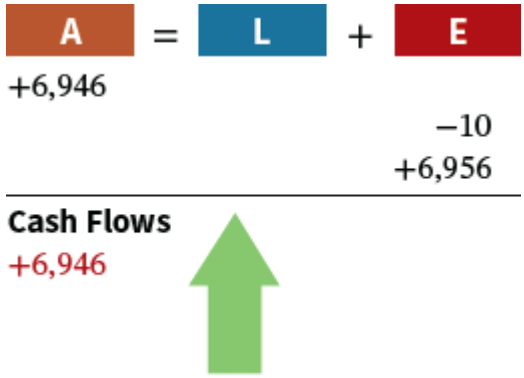
This system for handling cash receipts uses an important internal control principle—segregation of recordkeeping from physical custody.

- The supervisor has access to the cash register tape but **not** to the cash.
- The clerk and the cashier have access to the cash but **not** to the register tape.
- In addition, the cash register tape provides documentation and enables independent internal verification.
- Use of these three principles of internal control (segregation of recordkeeping from physical custody, documentation, and independent internal verification) provides an effective system of internal control. Any attempt at fraudulent activity should be detected unless there is collusion among the employees.

In some instances, the amount deposited at the bank will not agree with the cash recorded in the accounting records based on the cash register tape. These differences often result because the clerk hands incorrect change back to the retail customer. In this case, the difference between the

actual cash and the amount reported on the cash register tape is reported in a Cash Over and Short account. For example, suppose that the cash register tape indicated sales of 6,956 but the amount of cash was only 6,946. A cash shortfall of 10 exists. To account for this cash shortfall and related cash, the company makes the following entry.

Cash	6,946	
Cash Over and Short	10	
Sales Revenue		6,956
(To record cash shortfall)		



Cash Over and Short is an income statement item. It is reported as miscellaneous expense when there is a cash shortfall, and as miscellaneous revenue when there is an overage. Clearly, the amount should be small. Any material amounts in this account should be investigated.

Electronic Receipts

Electronic funds transfer (EFT) uses wire, telephone, or computers to transfer funds from one location to another. Examples of EFTs include the following.

- Direct deposit of payroll amounts to employees.
- Online bill payments for utilities and loans.
- Use of a debit card at point-of-sale (POS) terminals.

Not only do many businesses rely on EFTs as an efficient way to manage their cash, they also depend on their banks to maintain strong internal controls to safeguard it.

Because EFT does not involve employees handling cash, it reduces some of the opportunities for employee theft. However, opportunities still exist, especially in businesses that lack proper controls. Without assignment of responsibility or segregation of duties, an employee might redirect funds into a personal account and hide the theft with fraudulent accounting entries.

Check Receipts

Although the use of checks by retail customers has diminished significantly, checks continue to be used in business-to-business transactions. When a check is received at the time of sale, it will be included in the cash register and form part of an employee's reconciliation of daily sales to cash on hand.

- When a check is received in the mail, it is usually accompanied by a remittance advice, which is the detachable part of the invoice that customers are asked to send back with the check.
- Mailroom employees send the remittance advices to the accountants responsible for recording cash receipts, who then send the checks to another employee, who then deposits the checks at the bank (segregation of duties).
- The employee making the bank deposit should have no recordkeeping duties so that he or she is prevented from stealing the cash and covering up the theft by understating the value of cash receipt journal entries.

The person making the bank deposit will receive a bank-stamped deposit slip. Each day, an independent employee compares the amount of cash deposited per the deposit slip with the amount of cash receipts recorded that day to ensure the funds deposited were also recorded. If duties are segregated this way, no one employee would be able to steal and also be able to record the receipts to cover up the theft. The independent internal verification of the deposit slips further strengthens the controls over check receipts.

DO IT! 2a

Control over Cash Receipts

L. R. Cortez is concerned about the control over cash receipts in his fast-food restaurant, Big Cheese. The restaurant has two cash registers. At no time do more than two employees take customer orders and enter sales. Work shifts for employees range from 4 to 8 hours. Cortez asks your help in installing a good system of internal control over cash receipts.

ACTION PLAN

- **Differentiate among the internal control principles of (1) establishing responsibility, (2) using physical controls, and (3) independent internal verification.**
- **Design an effective system of internal control over cash receipts.**

Solution

Related exercise material: **BE7.5**, **BE7.6**, **BE7.7**, **BE7.8**, **DO IT! 7.2a**, **E7.2**, **E7.3**, **E7.4**, **E7.5**, **and E7.6**.

Cash Disbursements Controls

Companies disburse cash for a variety of reasons, such as to pay expenses and liabilities or to purchase assets. **Generally, internal control over cash disbursements is more effective when companies pay by check or electronic funds transfer (EFT) rather than by cash.** One exception is **payments for incidental amounts that are paid out of petty cash**.[2]

Companies generally issue checks only after following specified control procedures. **Illustration 7.6** shows how principles of internal control apply to cash disbursements.

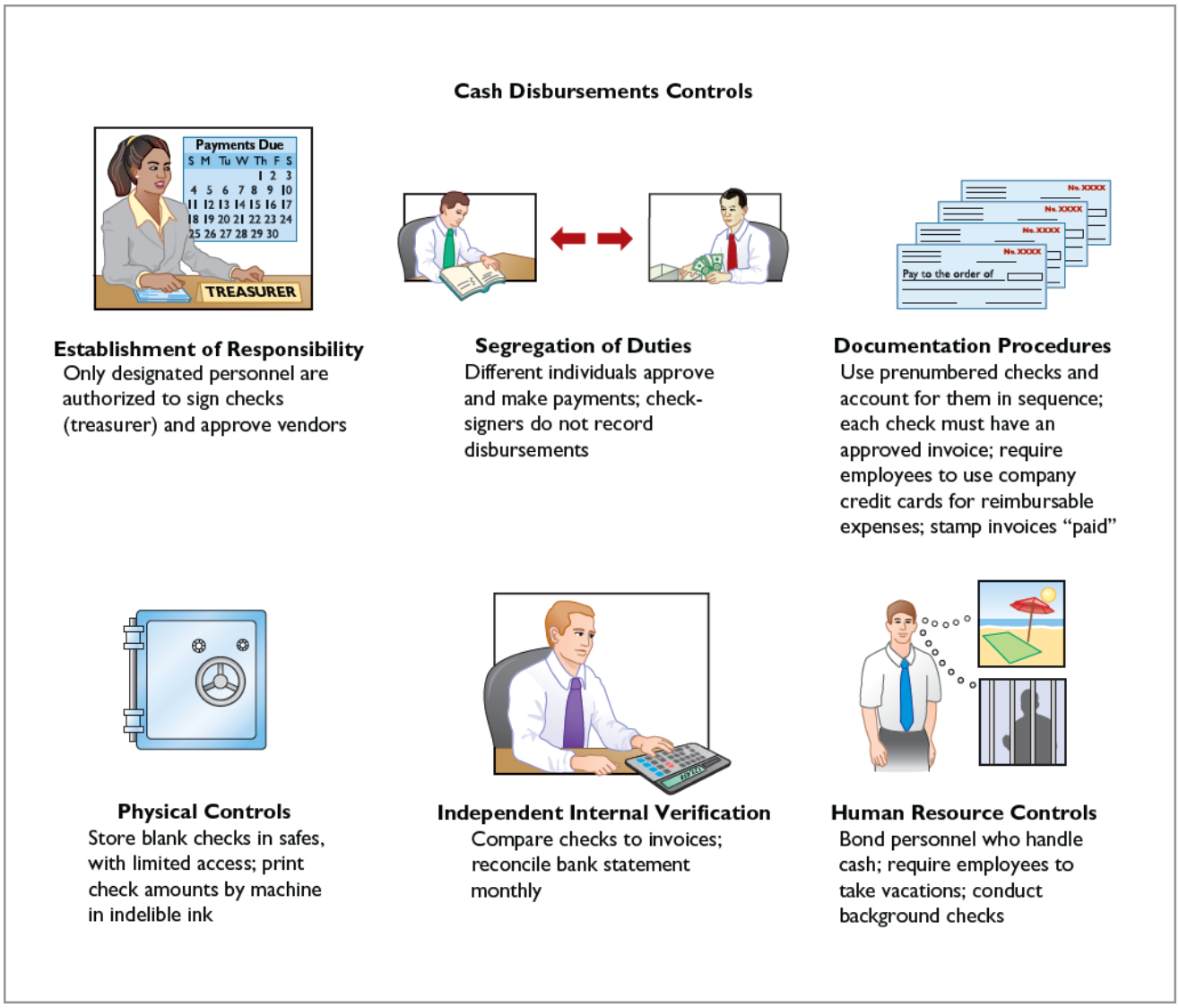
Voucher System Controls

Most medium and large companies use vouchers as part of their internal control over cash disbursements. A **voucher system** is a network of approvals by authorized individuals, acting independently, to ensure that all disbursements by check are proper.

The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A **voucher** is an authorization form prepared for each expenditure. Companies require vouchers for all types of cash disbursements except those from petty cash.

- The starting point in preparing a voucher is to fill in the appropriate information about the liability on the face of the voucher. The vendor's invoice provides most of the needed information.
- Then, an employee in accounts payable records the voucher (in a journal called a **voucher register**) and files it according to the date on which it is to be paid.
- The company issues and sends a check on that date, and stamps the voucher "paid."
- The paid voucher is sent to the accounting department for recording (in a journal called the **check register**).

ILLUSTRATION 7.6 Application of internal control principles to cash disbursements



A voucher system involves two journal entries, one to record the liability when the voucher is issued and a second to pay the liability that relates to the voucher.

The use of a voucher system, whether done manually or electronically, improves internal control over cash disbursements in two ways.

1. The authorization process inherent in a voucher system establishes responsibility. Each individual has responsibility to review the underlying documentation to ensure that it is correct.
2. The voucher system keeps track of the documents that back up each transaction. By keeping these documents in one place, a supervisor can independently verify the authenticity of each transaction.

Petty Cash Fund

As you just learned, better internal control over cash disbursements is possible when companies make payments by check. However, using checks to pay small amounts is both impractical and a nuisance. For instance, a company would not want to write checks to pay for postage due, working lunches, or taxi fares. A common way of handling such payments, while maintaining satisfactory control, is to use a **petty cash fund** to pay relatively small amounts (see **Ethics Note**). The operation of a petty cash fund, often called an **imprest system**, involves:

> **Ethics Note**
>
> **Petty cash funds are authorized and legitimate. In contrast, "slush" funds are unauthorized and hidden (under the table).**

1. Establishing the fund.
2. Making payments from the fund.
3. Replenishing the fund.[3]

Establishing the Petty Cash Fund

1. Two essential steps in establishing a petty cash fund are as follows.
2. Appointing a petty cash custodian who will be responsible for the fund.
3. Determining the size of the fund.

Ordinarily, a company expects the amount in the fund to cover anticipated disbursements for a three- to four-week period.

To establish the fund, a company issues a check payable to the petty cash custodian for the stipulated amount. For example, if Zhū Ltd. decides to establish a NT$3,000 fund on March 1, the general journal entry is as follows.

Mar. 1	Petty Cash	3,000	
	Cash		3,000
	(To establish a petty cash fund)		

A	=	L	+	E
+3,000				
−3,000				

Cash Flows
no effect

The fund custodian cashes the check and places the proceeds in a locked petty cash box or drawer. Most petty cash funds are established on a fixed-amount basis. The company will make no additional entries to the Petty Cash account unless management changes the stipulated amount of the fund. For example, if Zhū decides on July 1 to increase the size of the fund to NT$7,500, it would debit Petty Cash NT$4,500 and credit Cash NT$4,500.

Making Payments from the Petty Cash Fund

The petty cash custodian has the authority to make payments from the fund that conform to prescribed management policies. Usually, management limits the size of expenditures that come from petty cash. Likewise, it may not permit use of the fund for certain types of transactions (such as making short-term loans to employees).

Each payment from the fund must be documented on a prenumbered petty cash receipt (or petty cash voucher), as shown in **Illustration 7.7** (see **Helpful Hint**). The signatures of both the fund custodian and the person receiving payment are required on the receipt. If other supporting documents such as a freight bill or invoice are available, they should be attached to the petty cash receipt.

> **HELPFUL HINT**
>
> **The petty cash receipt satisfies two internal control principles: (1) establishment of responsibility (signature of custodian), and (2) documentation procedures.**

- The petty cash custodian keeps the receipts in the petty cash box until the fund is replenished.
- The sum of the petty cash receipts and the money in the fund should equal the established total at all times.
- Management can (and should) make surprise counts at any time (or use an independent person, such as an internal auditor) to determine the correctness of the fund.

The company does not make an accounting entry to record a payment when it is made from petty cash. It is considered both inexpedient and unnecessary to do so. Instead, the company recognizes the accounting effects of each payment when it replenishes the fund.

ILLUSTRATION 7.7 Petty cash receipt

Replenishing the Petty Cash Fund

When the money in the petty cash fund reaches a minimum level, the company replenishes the fund as follows (see Helpful Hint).

> **HELPFUL HINT**
>
> **Replenishing the petty cash fund involves three internal control procedures:**
>
> 1. **Segregation of duties.**
> 2. **Documentation procedures.**
> 3. **Independent internal verification.**

1. The petty cash custodian initiates a request for reimbursement. The individual prepares a schedule (or summary) of the payments that have been made and sends the schedule, supported by petty cash receipts and other documentation, to the treasurer's office.
2. The treasurer's office examines the receipts and supporting documents to verify that proper payments from the fund were made.
3. The treasurer then approves the request and issues a check to restore the fund to its established amount. At the same time, all supporting documentation is stamped "paid" so that it cannot be submitted again for payment.

To illustrate, assume that on March 15 Zhū Ltd.'s petty cash custodian requests a check for NT$2,610. The fund contains NT$390 cash and petty cash receipts for postage NT$1,320, freight-out NT$1,140, and miscellaneous expenses NT$150. The general journal entry to record the check is as follows.

Mar. 15	Postage Expense	1,320	
	Freight-Out	1,140	
	Miscellaneous Expense	150	
	Cash		2,610
	(To replenish petty cash fund)		

Note that the reimbursement entry does not affect the Petty Cash account.

- Replenishment changes the composition of the fund by replacing the petty cash receipts with cash.
- It does not change the balance in the fund.

Occasionally, in replenishing a petty cash fund, the company may need to recognize a cash shortage or overage (see **Helpful Hint**). This results when the total of the cash plus receipts in the petty cash box does not equal the established amount of the petty cash fund. To illustrate, assume that Zhū's petty cash custodian has only NT$360 in cash in the fund plus the receipts as listed. The request for reimbursement would therefore be for NT$2,640, and Zhū would make the following entry.

> **HELPFUL HINT**
>
> **Cash over and short situations result from mathematical errors or from failure to keep accurate records.**

Mar. 15	Postage Expense	1,320	
	Freight-Out	1,140	
	Miscellaneous Expense	150	
	Cash Over and Short	30	
	Cash		2,640
	(To replenish petty cash fund)		

Conversely, if the custodian has NT$420 in cash, the reimbursement request would be for NT$2,580. The company would credit Cash Over and Short for NT$30 (overage). A company reports a debit balance in Cash Over and Short in the income statement as miscellaneous expense. It reports a credit balance in the account as miscellaneous revenue. The company closes Cash Over and Short to Income Summary at the end of the year.

Companies should replenish a petty cash fund **at the end of the accounting period, regardless of the cash in the fund**. Replenishment at this time is necessary in order to recognize the effects of the petty cash payments on the financial statements.

Internal control over a petty cash fund is strengthened by:

1. Having a supervisor make surprise counts of the fund to ascertain whether the paid petty cash receipts and fund cash equal the designated amount.
2. Cancelling or mutilating the paid petty cash receipts so they cannot be resubmitted for reimbursement.

Ethics Insight

How Employees Steal

Occupational fraud is using your own occupation for personal gain through the misuse or misapplication of the company's resources or assets. This type of fraud is one of three types:

1. **Asset misappropriation**, such as theft of cash on hand, fraudulent disbursements, false refunds, ghost employees, personal purchases, and fictitious employees. This fraud is the most common but the least costly.
2. **Corruption**, such as bribery, illegal gratuities, and economic extortion. This fraud generally falls in the middle between asset misappropriation and financial statement fraud as regards frequency and cost.

3. **Financial statement fraud**, such as fictitious revenues, concealed liabilities and expenses, improper disclosures, and improper asset values. This fraud occurs less frequently than other types of fraud but it is the most costly.

The graph shows the frequency and the median loss for each type of occupational fraud. (Note that the sum of percentages exceeds 100% because some cases of fraud involved more than one type.)

Source: Adapted from *2018 Report to the Nations on Occupational Fraud and Abuse*, Association of Certified Fraud Examiners, pp. 10–12.

How can companies reduce the likelihood of occupational fraud?

Answer

DO IT! 2b

Petty Cash Fund

Bateer Company established a $50 petty cash fund on July 1. On July 30, the fund had $12 cash remaining and petty cash receipts for postage $14, office supplies $10, and delivery expense $15. Prepare journal entries to establish the fund on July 1 and to replenish the fund on July 30.

ACTION PLAN

- **To establish the fund, set up a separate general ledger account.**
- **Determine how much cash is needed to replenish the fund: subtract the cash remaining from the petty cash fund balance.**
- **Total the petty cash receipts. Determine any cash over or short—the difference between the cash needed to replenish the fund and the total of the petty cash receipts.**
- **Record the expenses incurred according to the petty cash receipts when replenishing the fund.**

Solution

Related exercise material: **BE7.9**, **DO IT! 7.2b**, **E7.7**, **and E7.8**.

7.3 Control Features of a Bank Account

LEARNING OBJECTIVE 3

Identify the control features of a bank account.

The use of a bank contributes significantly to good internal control over cash. A company safeguards its cash by using a bank as a depository and clearinghouse for checks received and checks written. The use of a bank checking account minimizes the amount of currency that must be kept on hand. It also facilitates control of cash because a double record is maintained of all bank transactions—one by the business and the other by the bank. The asset account Cash maintained by the company is the "flipside" of the bank's liability account for that company.

- A **bank reconciliation** is the process of comparing the bank's balance with the company's balance.
- It explains the differences to make them agree.

Many companies have more than one bank account. For efficiency of operations and better control, retailers like **Matahari Department Store** (IDN) and **Wumart** (CHN) often have regional bank accounts. Similarly, a company such as **ExxonMobil** (USA) with more than 100,000 employees may have a payroll bank account as well as one or more general bank accounts. In addition, a company may maintain several bank accounts in order to have more than one source for short-term loans.

Making Bank Deposits

An authorized employee, such as the head cashier, should make a company's bank deposits. Each deposit must be documented by a deposit slip (ticket), as shown in **Illustration 7.8**.

Deposit slips are prepared in duplicate. The bank retains the original; the depositor keeps the duplicate, machine-stamped by the bank to establish its authenticity.

ILLUSTRATION 7.8 Deposit slip

Writing Checks

A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. There are three parties to a check:

1. The **maker** (or drawer) who issues the check.
2. The **bank** (or payer) on which the check is drawn.
3. The **payee** to whom the check is payable.

A check is a **negotiable instrument** that one party can transfer to another party by endorsement. Each check should be accompanied by an explanation of its purpose. In many companies, a remittance advice attached to the check, as shown in **Illustration 7.9**, explains the check's purpose.

ILLUSTRATION 7.9 Check with remittance advice

Electronic Banking

Most businesses today take advantage of electronic banking using a computer or mobile banking on a mobile device. Many banks have websites where customers can access their account information. Banks must ensure that these websites are secure and require users to have strong passwords and to change passwords frequently. Businesses must also incorporate strong internal controls, such as the following.

- Marking a check as deposited once a picture is taken and electronically submitted to the bank (called remote deposit capture) to ensure the check is not deposited twice (see **Illustration 7.10**).
- Safeguarding checks to ensure they are not stolen or misused.
- Documenting the use of the cash withdrawn from the ATM.

ILLUSTRATION 7.10 Mobile banking using a smart phone (check deposit)

Bank Statements

Each month, the company receives from the bank a **bank statement** showing its bank transactions and balances (see **Helpful Hint**).[4] For example, the statement for Cray Gourmet in **Illustration 7.11** shows the following.

> **HELPFUL HINT**
>
> **Essentially, the bank statement is a copy of the bank's records sent to the customer or made available online for review.**

1. Checks paid and other debits (such as debit card transactions or electronic funds transfers for bill payments) that reduce the balance in the depositor's account.
2. Deposits (by direct deposit, automated teller machine, or electronic funds transfer) and other credits that increase the balance in the depositor's account.
3. The account balance after each day's transactions.

Remember that **bank statements are prepared from the *bank's* perspective**. For example, **every deposit the bank receives is an increase in the bank's liabilities (an account payable to the depositor)**. Therefore, in Illustration 7.11, Blom Bank France **credits** to Cray Gourmet every deposit it received from Cray. The reverse occurs when the bank "pays" a check issued by Cray Gourmet on its checking account balance: Payment reduces the bank's liability and is therefore **debited** to Cray's account with the bank.

The bank statement lists in numerical sequence all paid checks along with the date the check was paid and its amount. Upon paying a check, the bank stamps the check "paid"; a paid check is sometimes referred to as a **canceled** check. In addition, the bank includes with the bank statement memoranda explaining other debits and credits it made to the depositor's account.

- A check that is not paid by a bank because of insufficient funds in a bank account is called an **NSF check** (not sufficient funds).
- The bank uses a debit memorandum when a previously deposited customer's check "bounces" because of insufficient funds.
- In such a case, the customer's bank marks the check NSF (not sufficient funds) and returns it to the depositor's bank. The bank then debits (decreases) the depositor's account, as shown by the symbol NSF in Illustration 7.11, and sends the NSF check and debit memorandum to the depositor as notification of the charge.

ILLUSTRATION 7.11 Bank statement

The NSF check creates an account receivable for the depositor and reduces cash in the bank account.

Reconciling the Bank Account

Because the bank and the company maintain independent records of the company's checking account, you might assume that the respective balances will always agree. In fact, the two balances are seldom the same at any given time, and both balances differ from the "correct or true" balance. Therefore, it is necessary to make the balance per books and the balance per bank agree with the correct or true amount—a process called **reconciling the bank account**. The need for reconciliation has two causes:

1. **Time lags** that prevent one of the parties from recording the transaction in the same period.
2. **Errors** by either party in recording transactions.

Time lags occur frequently. For example, several days may elapse between the time a company pays by check and the date the bank pays the check. Similarly, when a company uses the bank's night depository to make its deposits, there will be a difference of one day between the time the company records the receipts and the time the bank does so. A time lag also occurs whenever the bank mails a debit or credit memorandum to the company.

You might think that if a company never writes checks (for example, if a small company uses only a debit card or electronic funds transfers), it does not need to reconcile its account. However, **the possibility of errors or fraud still necessitates periodic reconciliation**. The incidence of errors or fraud depends on the effectiveness of the internal controls maintained by the company and the bank. Bank errors are infrequent. However, either party could accidentally record a €450 check as €45 or €540. In addition, the bank might mistakenly charge a check drawn by G. Dufour to the account of G. Dupont.

Reconciliation Procedure

In reconciling the bank account, it is customary to reconcile the balance per books and balance per bank to their adjusted (correct or true) cash balances.

- **To obtain maximum benefit from a bank reconciliation, an employee who has no other responsibilities related to cash should prepare the reconciliation.**
- When companies do not follow the internal control principle of independent internal verification in preparing the reconciliation, cash embezzlements may escape unnoticed.

Illustration 7.12 shows the reconciliation process. The starting point in preparing the reconciliation is to enter the balance per bank statement and balance per books on a schedule (see Helpful Hint). The following steps should reveal all the reconciling items that cause the difference between the two balances.

> **HELPFUL HINT**
>
> **Deposits in transit and outstanding checks are reconciling items because of time lags.**

ILLUSTRATION 7.12 Bank reconciliation adjustments

Reconciling Items per Bank

On the bank side of the reconciliation, the items to reconcile are deposits in transit (amounts added), outstanding checks (amounts deducted), and bank errors (if any). By adjusting the bank balance for these items, a company brings that balance up to date.

Step 1. **Deposits in transit (+).** Compare the individual deposits on the bank statement with the deposits in transit from the preceding bank reconciliation and with the deposits per company records or copies of duplicate deposit slips. Deposits recorded by the depositor that have not been recorded by the bank represent **deposits in transit**. Add these deposits to the balance per bank.

Step 2. **Outstanding checks (−).** Compare the paid checks shown on the bank statement or the paid checks returned with the bank statement with (a) checks outstanding from the preceding bank reconciliation, and (b) checks issued by the company recorded as cash payments. Issued checks recorded by the company that have not been paid by the bank represent **outstanding checks**. Deduct outstanding checks from the balance per bank.

Step 3. **Bank errors (+/−).** Note any errors made by the bank that were discovered in the previous steps. For example, if the bank processed a deposit of €1,693 as €1,639 in error, the difference of €54 (€1,693 − €1,639) is added to the balance per bank on the bank reconciliation. All errors made by the bank are reconciling items in determining the adjusted cash balance per the bank.

Reconciling Items per Books

Reconciling items on the book side relate to amounts not yet recorded on the company's books and include adjustments from deposits and other amounts added, payments and other amounts deducted, and company errors (if any).

Step 1. **Other deposits (+).** Compare the other deposits on the bank statement with the company records. Any unrecorded amounts should be added to the balance per books. For example, if the bank statement shows electronic funds transfers from customers paying their accounts online, these amounts should be added to the balance per books on the bank reconciliation to update the company's records unless they had previously been recorded by the company.

Step 2. **Other payments (−).** Similarly, any unrecorded other payments should be deducted from the balance per books. For example, if the bank statement shows service charges (such as debit and credit card fees and other bank service charges), this amount is deducted from the balance per books on the bank reconciliation to make the company's records agree with the bank's records. **Normally, the company will already have recorded electronic payments.** However, if this has not been the case then these payments must be deducted from the balance per books on the bank reconciliation to make the company's records agree with the bank's records.

Step 3. **Book errors (+/−).** Note any errors made by the depositor that have been discovered in the previous steps. For example, say a company wrote check No. 443 to a supplier in the amount of €1,226 on April 12, but the accounting clerk recorded the check amount as €1,262. The error of €36 (€1,262 – €1,226) is added to the balance per books because the company reduced the balance per books by €36 too much when it recorded the check as €1,262 instead of €1,226. Only errors made by the company, not the bank, are included as reconciling items in determining the adjusted cash balance per books.

Bank Reconciliation Illustrated

Illustration 7.11 presented the bank statement for Cray Gourmet which the company accessed online (see **Helpful Hint**). It shows a balance per bank of €15,907.45 on April 30, 2025. On this date the balance of cash per books is €11,709.45.

> **HELPFUL HINT**
>
> **Note in the bank statement in Illustration 7.10 that the bank has paid checks No. 459 and 461, but check No. 460 is not listed. Thus, this check is outstanding. If a complete bank statement were provided, checks No. 453 and 457 also would not be listed. Cray obtains the amounts for these three checks from its cash payments records.**

From the foregoing steps, Cray determines the following reconciling items for the bank.

Step 1.	**Deposits in transit (+):** April 30 deposit (received by bank on May 1).	€2,201.40
Step 2.	**Outstanding checks (−):** No. 453, €3,000.00; No. 457, €1,401.30; No. 460, €1,502.70.	5,904.00
Step 3.	**Bank errors (+/−):** None.	

Reconciling items per books are as follows.

Step 1.	**Other deposits (+):** Unrecorded electronic receipt from customer on account on April 9 determined from the bank statement.	€1,035.00
Step 2.	**Other payments (−):** The electronic payments on April 3 and 7 were previously recorded by the company when they were initiated. Unrecorded charges determined from the bank statement are as follows:	
	Returned NSF check on April 29	425.60
	Debit and credit card fees on April 30	120.00
	Bank service charges on April 30	30.00
Step 3.	**Company errors (+):** Check No. 443 was correctly written by Cray for €1,226 and was correctly paid by the bank on April 12. However, it was recorded as €1,262 on Cray's books.	36.00

Illustration 7.13 shows Cray's bank reconciliation (see **Alternative Terminology**).

ILLUSTRATION 7.13 Bank reconciliation

> **ALTERNATIVE TERMINOLOGY**
>
> **The terms adjusted cash balance, true cash balance, and correct cash balance are used interchangeably.**

Entries from Bank Reconciliation

The depositor (that is, the company) next must record each reconciling item used to determine the **adjusted cash balance per books**. If the company does not journalize and post these items, the Cash account will not show the correct balance. The adjusting entries for the Cray Gourmet bank reconciliation on April 30 are as follows (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **These entries are adjusting entries. In prior chapters, we considered Cash an account that did not require adjustment because we had not yet explained a bank reconciliation.**

Collection of Electronic Funds Transfer

A payment of an account by a customer is recorded in the same way, whether the cash is received through the mail or electronically. The entry is as follows.

Apr. 30	Cash	1,035	
	Accounts Receivable		1,035
	(To record receipt of electronic funds transfer)		

Book Error

An examination of the cash disbursements journal shows that check No. 443 was a payment on account to Roux Foods, a supplier. The correcting entry is as follows.

Apr. 30	Cash	36	
	Accounts Payable		36
	(To correct error in recording check No. 443)		

NSF Check

As indicated earlier, an NSF check becomes an accounts receivable to the depositor. The entry is as follows.

Apr. 30	Accounts Receivable	425.60	
	Cash		425.60
	(To record NSF check)		

Bank Charge Expense

Fees for processing debit and credit card transactions are normally debited to the Bank Charge Expense account, as are bank service charges. We have chosen to combine and record these in one journal entry, as shown below, although they also could be journalized separately.

Apr. 30	Bank Charge Expense	150	
	Cash		150
	(To record charges for debit and credit card fees of €120 and bank service charges of €30)		

After Cray posts the entries, the Cash account will appear as in **Illustration 7.14**.

ILLUSTRATION 7.14 Adjusted balance in Cash account

Cash			
Apr. 30 Bal.	11,709.45	Apr. 30	425.60
30	1,035.00	30	150.00
30	36.00		
Apr. 30 Bal.	**12,204.85**		

The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in Illustration 7.13.

What entries does the bank make? If the company discovers any bank errors in preparing the reconciliation, it should notify the bank so the bank can make the necessary corrections on its records. The bank does not make any entries for deposits in transit or outstanding checks. Only when these items reach the bank will the bank record these items.

Investor Insight

Madoff's Ponzi Scheme

No recent fraud has generated more interest and rage than the one perpetrated by Bernard Madoff. Madoff was an elite New York investment fund manager who was highly regarded by securities regulators. Investors flocked to him because he delivered very steady returns of between 10% and 15%, no matter whether the market was going up or going down.

However, for many years, Madoff did not actually invest the cash that people gave to him. Instead, he was running a Ponzi scheme: He paid returns to existing investors using cash received from new investors. As long as the size of his investment fund continued to grow from new investments at a rate that exceeded the amounts that he needed to pay out in returns, Madoff was able to operate his fraud smoothly.

To conceal his misdeeds, Madoff fabricated false investment statements that were provided to investors. In addition, Madoff hired an auditor that never verified the accuracy of the investment records but automatically issued unqualified opinions each year. A competing fund manager warned the U.S. SEC a number of times over a nearly 10-year period that he thought Madoff was engaged in fraud. The U.S. SEC never aggressively investigated the allegations. Investors, many of which were charitable organizations, lost more than $18 billion. Madoff was sentenced to a jail term of 150 years.

How was Madoff able to conceal such a giant fraud?

Answer

DO IT! 3

Bank Reconciliation

Deepika Kann owns Deepika Fine Fabrics. Deepika asks you to explain how she should treat the following reconciling items when reconciling the company's bank account: (1) a debit memorandum for an NSF check, (2) a credit memorandum received by the bank for an electronic funds transfer from one of the company's customers, (3) outstanding checks, and (4) a deposit in transit.

ACTION PLAN

- **Understand the purpose of a bank reconciliation.**
- **Identify time lags and explain how they cause reconciling items.**

Solution

Related exercise material: **BE7.10**, **BE7.11**, **BE7.12**, **BE7.13**, **BE7.14**, **BE7.15**, **DO IT! 7.3**, **E7.9**, **E7.10**, **E7.11**, **E7.12**, **and E7.13**.

7.4 Reporting Cash

LEARNING OBJECTIVE 4

Explain the reporting of cash.

Cash consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository. Companies report cash in two different statements:

1. The statement of financial position, which reports the amount of cash available at a given point in time.
2. The statement of cash flows, which shows the sources and uses of cash during a period of time. (The statement of cash flows was introduced in Chapter 1 and will be discussed in much detail in Chapter 14.)

In this section, we discuss some important points regarding the presentation of cash in the statement of financial position.

When presented in a statement of financial position, cash on hand, cash in banks, and petty cash are often combined and reported simply as **Cash**. Because it is the most liquid asset owned by the company, cash is generally listed last in the current assets section of the statement of financial position.

Cash Equivalents

Many companies use the designation "Cash and cash equivalents" in reporting cash. (See **Illustration 7.15** for an example.) **Cash equivalents** are short-term, highly liquid investments that are both:

1. Readily convertible to known amounts of cash.
2. So near their maturity that their market value is relatively insensitive to changes in interest rates. (Generally, only investments with original maturities of three months or less qualify under this definition.)

ILLUSTRATION 7.15 Statement of financial position presentation of cash

Examples of cash equivalents are Treasury bills, commercial paper (short-term company notes), and money market funds. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes (see Ethics Note).

> **ETHICS NOTE**
>
> **Recently, some companies were forced to restate their financial statements because they had too broadly interpreted which types of investments could be treated as cash equivalents. By reporting these items as cash equivalents, the companies made themselves look more liquid.**

Occasionally, a company will have a net negative balance in its bank account. In this case, the company should report the negative balance among current liabilities. For example, farm equipment manufacturer **Ag-Chem** (USA) at one time reported "Checks outstanding in excess of cash balances" of $2,145,000 among its current liabilities.

Restricted Cash

A company may have **restricted cash**, cash that is not available for general use but rather is restricted for a special purpose. For example, **Takung Art Co., Ltd.** (CHN) recently reported restricted cash of ¥25,676,519. The cash is earmarked for the purpose of buying and selling ownership units of artwork.

Restricted cash should be disclosed along with additional information about the nature of the restriction. In addition, the company must consider whether the nature of the restrictions result in the investment ceasing to qualify as highly liquid or readily convertible. In this case, the amount of restricted cash would no longer be included as in the total of Cash and cash equivalents.

DO IT! 4

Reporting Cash

Indicate whether each of the following statements is true or false. If false, indicate how to correct the statement.

1. Cash and cash equivalents are comprised of coins, currency (paper money), money orders, and NSF checks.
2. The amount of restricted cash should be disclosed along with the nature of the restrictions.
3. A company may have a negative balance in its bank account. In this case, it should offset this negative balance against cash and cash equivalents on the statement of financial position.
4. Because cash and cash equivalents often includes short-term investments, accounts receivable should be reported as the last item on the statement of financial position.

ACTION PLAN

- **Understand how companies present cash and restricted cash on the statement of financial position.**
- **Review the designations of cash equivalents and restricted cash, and how companies typically handle them.**

Solution

Related exercise material: **BE7.16**, **DO IT! 7.4**, **E7.14**, **and E7.15**.

Review and Practice

Learning Objectives Review

1 Define fraud and the principles of internal control.

A fraud is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. The fraud triangle refers to the three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization. Internal control consists of all the related methods and measures adopted within an organization to safeguard its assets, enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations.

The principles of internal control are establishment of responsibility, segregation of duties, documentation procedures, physical controls, independent internal verification, and human resource controls such as bonding and requiring employees to take vacations.

2 Apply internal control principles to cash.

Internal controls over cash receipts include (a) designating specific personnel to handle cash; (b) assigning different individuals to receive cash, record cash, and maintain custody of cash; (c) using remittance advices for mail receipts, cash register tapes for over-the-counter receipts, and deposit slips for bank deposits; (d) using company safes and bank vaults to store cash with access limited to authorized personnel, and using cash registers or point-of-sale terminals in executing over-the-

counter receipts; (e) making independent daily counts of register receipts and daily comparison of total receipts with total deposits; and (f) bonding personnel that handle cash and requiring them to take vacations.

Internal controls over cash disbursements include (a) having specific individuals such as the treasurer authorized to sign checks and approve vendors; (b) assigning different individuals to approve items for payment, make the payment, and record the payment; (c) using prenumbered checks and accounting for all checks, with each check supported by an approved invoice; (d) storing blank checks in a safe or vault with access restricted to authorized personnel, and using a check-writing machine to imprint amounts on checks; (e) comparing each check with the approved invoice before issuing the check, and making monthly reconciliations of bank and book balances; and (f) bonding personnel who handle cash, requiring employees to take vacations, and conducting background checks.

Companies operate a petty cash fund to pay relatively small amounts of cash. They must establish the fund, make payments from the fund, and replenish the fund when the cash in the fund reaches a minimum level.

3 Identify the control features of a bank account.

A bank account contributes to good internal control by providing physical controls for the storage of cash. It minimizes the amount of currency that a company must keep on hand, and it creates a double record of a depositor's bank transactions. It is customary to reconcile the balance per books and balance per bank to their adjusted balances. The steps in the reconciling process are to determine deposits in transit and electronic funds transfers received by bank, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.

4 Explain the reporting of cash.

Companies list cash last in the current assets section of the statement of financial position. In some cases, they report cash together with cash equivalents. Cash restricted for a special purpose is reported separately as a current asset or as a non-current asset, depending on when the cash is expected to be used.

Glossary Review

Bank reconciliation
The process of comparing the bank's balance of an account with the company's balance and explaining any differences to make them agree.

Bank statement
A monthly statement from the bank that shows the depositor's bank transactions and balances.

Bonding
Obtaining insurance protection against theft by employees.

Cash
Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository.

Cash equivalents
Short-term, highly liquid investments that can be converted to a specific amount of cash.

Check
A written order signed by a bank depositor, directing the bank to pay a specified sum of money to a designated recipient.

Deposits in transit
Deposits recorded by the depositor but not yet recorded by the bank.

Electronic funds transfer (EFT)

A disbursement system that uses wire, telephone, or computers to transfer funds from one location to another.

Fraud
A dishonest act by an employee that results in personal benefit to the employee at a cost to the employer.

Fraud triangle
The three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization.

Internal auditors
Company employees who continuously evaluate the effectiveness of the company's internal control system.

Internal control
A process designed to provide reasonable assurance regarding the achievement of company objectives related to operations, reporting, and compliance.

NSF check
A check that is not paid by a bank because of insufficient funds in a customer's bank account.

Outstanding checks
Checks issued and recorded by a company but not yet paid by the bank.

Petty cash fund
A cash fund used to pay relatively small amounts.

Restricted cash
Cash that must be used for a special purpose.

Voucher
An authorization form prepared for each payment in a voucher system.

Voucher system
A network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper.

Practice Multiple-Choice Questions

1. **(LO 1)** Which of the following is **not** an element of the fraud triangle?

   a. Rationalization.

   b. Financial pressure.

   c. Segregation of duties.

   d. Opportunity.

Solution

2. **(LO 1)** An organization uses internal control to enhance the accuracy and reliability of accounting records and to:

   a. safeguard assets.

   b. prevent fraud.

   c. produce correct financial statements.

   d. deter employee dishonesty.

Solution

3. **(LO 1)** The principles of internal control do **not** include:

   a. establishment of responsibility.

b. documentation procedures.

c. management responsibility.

d. independent internal verification.

Solution

4. **(LO 1)** Physical controls do **not** include:

a. safes and vaults to store cash.

b. independent bank reconciliations.

c. locked warehouses for inventories.

d. bank safety deposit boxes for important papers.

Solution

5. **(LO 1)** Which of the following control activities is **not** relevant when a company uses a computerized (rather than manual) accounting system?

a. Establishment of responsibility.

b. Segregation of duties.

c. Independent internal verification.

d. All of these control activities are relevant to a computerized system.

Solution

6. **(LO 2)** Permitting only designated personnel to handle cash receipts is an application of the principle of:

a. segregation of duties.

b. establishment of responsibility.

c. independent internal verification.

d. human resource controls.

Solution

7. **(LO 2)** The use of prenumbered checks in disbursing cash is an application of the principle of:

a. establishment of responsibility.

b. segregation of duties.

c. physical controls.

d. documentation procedures.

Solution

8. **(LO 2)** A company writes a check to replenish a €100 petty cash fund when the fund contains receipts of €94 and €4 in cash. In recording the check, the company should:

a. debit Cash Over and Short for €2.

b. debit Petty Cash for €94.

c. credit Cash for €94.

d. credit Petty Cash for €2.

Solution

9. **(LO 3)** The control features of a bank account do **not** include:

a. having bank auditors verify the correctness of the bank balance per books.

b. minimizing the amount of cash that must be kept on hand.

c. providing a double record of all bank transactions.

d. safeguarding cash by using a bank as a depository.

Solution

10. **(LO 3)** In a bank reconciliation, deposits in transit are:

a. deducted from the book balance.

b. added to the book balance.

c. added to the bank balance.

d. deducted from the bank balance.

Solution

11. **(LO 3)** The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is:

a. outstanding checks.

b. deposit in transit.

c. a bank error.

d. bank service charges.

Solution

12. **(LO 4)** Which of the following items in a cash drawer at November 30 is **not** cash?

a. Money orders.

b. Coins and currency.

c. An NSF check.

d. A customer check dated November 28.

Solution

13. **(LO 4)** Which of the following statements correctly describes the reporting of cash?

a. Cash cannot be combined with cash equivalents.

b. Restricted cash need not be disclosed.

c. Cash is listed last in the current assets section.

d. The nature of the restrictions on cash need not be disclosed.

Solution

Practice Brief Exercises

Prepare entry to replenish a petty cash fund.

1. **(LO 2)** On May 31, Tyler Lighting's petty cash fund of £200 is replenished when the fund contains £7 in cash and receipts for postage £105, freight-out £49, and miscellaneous expense £40. Prepare the journal entry to record the replenishment of the petty cash fund.

Solution

Prepare partial bank reconciliation.

2. (LO 3) At August 31, Saladino Coffee has the following bank information: cash balance per bank 5,200, outstanding checks 1,462, deposits in transit 1,211, and a bank debit memo 110. Determine the adjusted cash balance per bank at July 31.

Solution

Explain the statement presentation of cash balances.

3. (LO 4) Zian Athletics has the following cash balances: Cash in Bank ¥18,762, Payroll Bank Account ¥8,000, Petty Cash ¥150, and Plant Expansion Fund Cash ¥30,000 to be used 2 years from now (amounts in thousands). Explain how each balance should be reported on the statement of financial position.

Solution

Practice Exercises

Indicate good or weak internal control procedures.

1. (LO 1, 2) Listed below are five procedures followed by Lee Enterprises.

1. Total cash receipts are compared to bank deposits daily by Wing Poon, who receives cash over the counter.
2. Employees write down hours worked and turn in the sheet to the cashier's office.
3. As a cost-saving measure, employees do not take vacations.
4. Only the sales manager can approve credit sales.
5. Three different employees are assigned one task each related to inventory: ship goods to customers, bill customers, and receive payment from customers.

Instructions

Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principles is violated. Use the table below.

Procedure	IC Good or Weak?	Related Internal Control Principle
1.		
2.		
3.		
4.		
5.		

Solution

Prepare bank reconciliation and adjusting entries.

2. (LO 3) The information below relates to the Cash account in the ledger of Ong Trading (amounts in thousands).

Balance June 1—¥9,947; Cash deposited—¥37,120.

Balance June 30—¥10,094; Checks written—¥36,973.

The June bank statement shows a balance of ¥9,525 on June 30 and the following memoranda.

Credits		Debits	
Collection of electronic funds transfer	¥884	NSF check: R. Doll	¥245
Interest earned on checking accounts	¥26	Safety deposit box rent	¥35

At June 30, deposits in transit were ¥2,581, and outstanding checks totaled ¥1,382.

Instructions

a. Prepare the bank reconciliation at June 30.

b. Prepare the adjusting entries at June 30, assuming the NSF check was from a customer on account.

Solution

Practice Problem

Prepare bank reconciliation and journalize entries.

(LO 3) Choi Group's bank statement for May 2025 shows the following data (amounts in thousands).

Balance 5/1	₩12,650	Balance 5/31	₩14,280
Debit memorandum:		Credit memorandum:	
NSF check	₩175	Collection of electronic funds transfer	₩505

The cash balance per books at May 31 is ₩13,319. Your review of the data reveals the following.

1. The NSF check was from Copple Co., a customer.
2. Outstanding checks at May 31 total ₩2,410.
3. Deposits in transit at May 31 total ₩1,752.
4. A Choi Group check for ₩352, dated May 10, cleared the bank on May 25. The company recorded this check, which was a payment on account, for ₩325.

Instructions

a. Prepare a bank reconciliation at May 31.

b. Journalize the entries required by the reconciliation.

Solution

Questions

1. A local bank reported that it lost $150,000 as the result of an employee fraud. Edward Jasso is not clear on what is meant by an "employee fraud." Explain the meaning of fraud to Edward and give an example of frauds that might occur at a bank.

2. Fraud experts often say that there are three primary factors that contribute to employee fraud. Identify the three factors and explain what is meant by each.

3. Identify the five components of a good internal control system.

4. "Internal control is concerned only with enhancing the accuracy of the accounting records." Do you agree? Explain.

5. What principles of internal control apply to most organizations?

6. In the corner grocery store, all sales clerks make change out of one cash register drawer. Is this a violation of internal control? Why?

7. Xi Ping is reviewing the principle of segregation of duties. What are the two common applications of this principle?

8. How do documentation procedures contribute to good internal control?

9. What internal control objectives are met by physical controls?

10. (a) Explain the control principle of independent internal verification. (b) What practices are important in applying this principle?

11. As the company accountant, the management of Faan Stores asks you to explain (a) the concept of reasonable assurance in internal control and (b) the importance of the human factor in internal control.

12. What principle(s) of internal control is (are) involved in making daily cash counts of over-the-counter receipts?

13. Assume that **Kohl's** (USA) installed new electronic cash registers in its department stores. How do cash registers improve internal control over cash receipts?

14. At Summato Wholesale, two mail clerks open all mail receipts. How does this strengthen internal control?

15. "To have maximum effective internal control over cash disbursements, all payments should be made by check." Is this true? Explain.

16. Deangelo Company's internal controls over cash disbursements provide for the treasurer to sign checks imprinted by a check-writing machine in indelible ink after comparing the check with the approved invoice. Identify the internal control principles that are present in these controls.

17. Explain how these principles apply to cash disbursements: (a) physical controls and (b) human resource controls.

18. (a) What is a voucher system? (b) What principles of internal control apply to a voucher system?

19. What is the essential feature of an electronic funds transfer (EFT) procedure?

20. (a) Identify the three activities that pertain to a petty cash fund and indicate an internal control principle that is applicable to each activity. (b) When are journal entries required in the operation of a petty cash fund?

21. "The use of a bank contributes significantly to good internal control over cash." Is this true? Why or why not?

22. Anna Korte is confused about the lack of agreement between the cash balance per books and the balance per bank. Explain the causes for the lack of agreement to Anna, and give an example of each cause.

23. Jung Ha Na asks your help concerning an NSF check. Explain to Jung (a) what an NSF check is, (b) how it is treated in a bank reconciliation, and (c) whether it will require an adjusting entry.

24. (a) "Cash equivalents are the same as cash." Do you agree? Explain. (b) Where and how should restricted cash funds be reported on the statement of financial position?

25. Riverside Fertilizer owns the following assets at the statement of financial position date.

Cash in bank savings account	€ 8,000
Cash on hand	850
Cash refund due from taxing authority	1,000
Checking account balance	14,000
Postdated checks	500

What amount should Riverside report as cash in the statement of financial position?

26. The financial statements of **TSMC** are presented in Appendix A. At what amount does the company report cash and cash equivalents in its 2020 consolidated statement of financial position?

Brief Exercises

Identify fraud triangle concepts.

BE7.1 (LO 1) Match each situation with the fraud triangle factor—opportunity, financial pressure, or rationalization—that best describes it.

a. An employee's monthly credit card payments are nearly 75% of his or her monthly earnings.

b. An employee earns minimum wage at a firm that has reported record earnings for each of the last five years.

c. An employee has an expensive gambling habit.

d. An employee has check-writing and signing responsibilities for a small company, as well as reconciling the bank account.

Indicate internal control concepts.

BE7.2 (LO 1) Ram Siram has prepared the following statements about internal control.

a. One of the objectives of internal control is to safeguard assets from employee theft, robbery, and unauthorized use.

b. One of the objectives of internal control is to enhance the accuracy and reliability of the accounting records.

Identify each statement as true or false. If false, indicate how to correct the statement.

Explain the importance of internal control.

BE7.3 (LO 1) Anusha Das is the new owner of Kolkata Parking. She has heard about internal control but is not clear about its importance for her business. Explain to Anusha the four purposes of internal control and give her one application of each purpose for Kolkata Parking.

Identify internal control principles.

BE7.4 (LO 1) The internal control procedures in Hamzah Electronics result in the following provisions. Identify the principles of internal control that are being followed in each case.

a. Employees who have physical custody of assets do not have access to the accounting records.

b. Each month, the assets on hand are compared to the accounting records by an internal auditor.

c. A prenumbered shipping document is prepared for each shipment of goods to customers.

Identify the internal control principles applicable to cash receipts.

BE7.5 (LO 2) Wu Hardware has the following internal control procedures over cash receipts. Identify the internal control principle that is applicable to each procedure.

a. All over-the-counter receipts are entered in cash registers.

b. All cashiers are bonded.

c. Daily cash counts are made by cashier department supervisors.

d. The duties of receiving cash, recording cash, and custody of cash are assigned to different individuals.

e. Only cashiers may operate cash registers.

Make journal entries for cash overage and shortfall.

BE7.6 (LO 2) The cash register tape for Bluestem Industries reported sales of $6,871.50. Record the journal entry that would be necessary for each of the following situations. (a) Cash to be accounted for exceeds cash on hand by $50.75. (b) Cash on hand exceeds cash to be accounted for by $28.32.

Make journal entry using cash count sheet.

BE7.7 (LO 2) While examining cash receipts information, the accounting department determined the following information: opening cash balance €160, cash on hand €1,125.74, and cash sales per register tape €980.83. Prepare the required journal entry based upon the cash count sheet.

Identify the internal control principles applicable to cash disbursements.

BE7.8 (LO 1, 2) Deutche Travel has the following internal control procedures over cash disbursements. Identify the internal control principle that is applicable to each procedure.

a. Company checks are prenumbered.

b. The bank statement is reconciled monthly by an internal auditor.

c. Blank checks are stored in a safe in the treasurer's office.

d. Only the treasurer or assistant treasurer may sign checks.

e. Check-signers are not allowed to record cash disbursement transactions.

Prepare entry to replenish a petty cash fund.

BE7.9 (LO 2) On March 20, Dody's petty cash fund of €100 is replenished when the fund contains €9 in cash and receipts for postage €52, freight-out €26, and travel expense €10. Prepare the journal entry to record the replenishment of the petty cash fund.

Identify the control features of a bank account.

BE7.10 (LO 3) Bei Yong is uncertain about the control features of a bank account. Explain the control benefits of (a) a check and (b) a bank statement.

Indicate location of reconciling items in a bank reconciliation.

BE7.11 (LO 3) The following reconciling items are applicable to the bank reconciliation for Ellington Company. Indicate how each item should be shown on a bank reconciliation: (a) outstanding checks, (b) bank debit memorandum for service charge, (c) bank credit memorandum for collecting a note for the depositor, and (d) deposits in transit.

Identify reconciling items that require adjusting entries.

BE7.12 (LO 3) Using the data in BE7.11, indicate (a) the items that will result in an adjustment to the depositor's records and (b) why the other items do not require adjustment.

Prepare partial bank reconciliation.

BE7.13 (LO 3) At July 31, Wenji Interiors has the following bank information (amounts in thousands): cash balance per bank ¥7,420, outstanding checks ¥762, deposits in transit ¥1,620, and a bank service charge ¥20. Determine the adjusted cash balance per bank at July 31.

Prepare partial bank reconciliation.

BE7.14 (LO 3) At August 31, Pratt Shipping has a cash balance per books of £9,500 and the following additional data from the bank statement: charge for printing Pratt Shipping checks £35, interest earned on checking account balance £40, and outstanding checks £800. Determine the adjusted cash balance per books at August 31.

Compute outstanding checks.

BE7.15 (LO 3) In the month of November, Fiesta Catering wrote checks in the amount of €9,750. In December, checks in the amount of €11,762 were written. In November, €8,800 of these checks were presented to the bank for payment, and €10,889 in December. What is the amount of outstanding checks at the end of November? At the end of December?

Explain the statement presentation of cash balances.

BE7.16 (LO 4) Zhang Company has the following cash balances: Cash in Bank $15,742, Payroll Bank Account $6,000, and Plant Expansion Fund Cash $25,000 to be used two years from now. Explain how each balance should be reported on the statement of financial position.

DO IT! Exercises

Identify violations of control activities.

DO IT! 7.1 (LO 1) Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for fraud or inappropriate accounting practices.

1. Once a month, the sales department sends sales invoices to the accounting department to be recorded.
2. Leah Hutcherson orders merchandise for Wular Lake Company; she also receives merchandise and authorizes payment for merchandise.
3. Several clerks at Great Foods use the same cash register drawer.

Design system of internal control over cash receipts.

DO IT! 7.2a (LO 2) Luo Yang is concerned with control over mail receipts at Yang's Tools. All mail receipts are opened by Rong Hu. Rong sends the checks to the accounting department, where they are stamped "For Deposit Only." The accounting department records and deposits the mail receipts weekly. Luo asks for your help in installing a good system of internal control over mail receipts.

Make journal entries for petty cash fund.

DO IT! 7.2b (LO 2) Wilkinson Company established a $100 petty cash fund on August 1. On August 31, the fund had $7 cash remaining and petty cash receipts for postage $31, office supplies $42, and miscellaneous expense $16. Prepare journal entries to establish the fund on August 1 and replenish the fund on August 31.

Explain treatment of items in bank reconciliation.

DO IT! 7.3 (LO 3) Roger Richman owns Richman Blankets. He asks you to explain how he should treat the following reconciling items when reconciling the company's bank account.

1. Outstanding checks.
2. A deposit in transit.
3. The bank charged to the company account a check written by another company.
4. A debit memorandum for a bank service charge.

Analyze statements about the reporting of cash.

DO IT! 7.4 (LO 4) Indicate whether each of the following statements is true or false (amounts in thousands).

1. A company has the following assets at the end of the year: cash on hand NT$40,000, cash refund due from customer NT$30,000, and checking account balance NT$22,000. Cash and cash equivalents is therefore NT$62,000.
2. A company that has received NSF checks should report these checks as a current liability on the statement of financial position.
3. Restricted cash is reported as part of cash and cash equivalents.
4. A company has cash in the bank of NT$50,000, petty cash of NT$400, and equity investments of NT$100,000. Total cash and cash equivalents is therefore NT$50,400.

Exercises

Identify the principles of internal control.

E7.1 (LO 1) Li Tung is the owner of Zhao Pizza. Zhao is operated strictly on a carryout basis. Customers pick up their orders at a counter where a clerk exchanges the pizza for cash. While at the counter, the customer can see other employees making the pizzas and the large ovens in which the pizzas are baked.

Instructions

Identify the six principles of internal control and give an example of each principle that you might observe when picking up your pizza. (*Note:* It may not be possible to observe all the principles.)

Identify internal control weaknesses over cash receipts and suggest improvements.

E7.2 (LO 1, 2) The following control procedures are used at Torres Company for over-the-counter cash receipts.

1. To minimize the risk of robbery, cash in excess of $100 is stored in an unlocked briefcase in the stockroom until it is deposited in the bank.
2. All over-the-counter receipts are processed by three clerks who use a cash register with a single cash drawer.
3. The company accountant makes the bank deposit and then records the day's receipts.
4. At the end of each day, the total receipts are counted by the cashier on duty and reconciled to the cash register total.
5. Cashiers are experienced; they are not bonded.

Instructions

a. For each procedure, explain the weakness in internal control, and identify the control principle that is violated.

b. For each weakness, suggest a change in procedure that will result in good internal control.

Identify internal control weaknesses over cash disbursements and suggest improvements.

E7.3 (LO 1, 2) The following control procedures are used in Mendy Lang's Boutique for cash disbursements.

1. The company accountant prepares the bank reconciliation and reports any discrepancies to the owner.
2. The store manager personally approves all payments before signing and issuing checks.
3. Each week, 100 company checks are left in an unmarked envelope on a shelf behind the cash register.
4. After payment, bills are filed in a paid invoice folder.
5. The company checks are unnumbered.

Instructions

a. For each procedure, explain the weakness in internal control, and identify the internal control principle that is violated.

b. For each weakness, suggest a change in the procedure that will result in good internal control.

Identify internal control weaknesses for cash disbursements and suggest improvements.

E7.4 (LO 2) Writing At Bun Company, checks are not prenumbered because both the purchasing agent and the treasurer are authorized to issue checks. Each signer has access to unissued checks kept in an unlocked file cabinet. The purchasing agent pays all bills pertaining to goods purchased for resale. Prior to payment, the purchasing agent determines that the goods have been received and verifies the mathematical accuracy of the vendor's invoice. After payment, the invoice is filed by the vendor name, and the purchasing agent records the payment. The treasurer pays all other bills following approval by authorized employees. After payment, the treasurer stamps all bills PAID, files them by payment date, and records the checks in the cash disbursements journal. Bun Company maintains one checking account that is reconciled by the treasurer.

Instructions

a. List the weaknesses in internal control over cash disbursements.

b. Write an email to the company treasurer indicating your recommendations for improvement.

Indicate whether procedure is good or weak internal control.

E7.5 (LO 1, 2) Listed below are five procedures followed by Eikenberry Hotels.

1. Several individuals operate the cash register using the same register drawer.
2. A monthly bank reconciliation is prepared by someone who has no other cash responsibilities.
3. Joe Cockrell writes checks and also records cash payment entries.
4. One individual orders inventory, while a different individual authorizes payments.
5. Unnumbered sales invoices from credit sales are forwarded to the accounting department every four weeks for recording.

Instructions

Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principle is violated. Use the table below.

Procedure	IC Good or Weak?	Related Internal Control Principle
1.		
2.		
3.		

Procedure	IC Good or Weak?	Related Internal Control Principle
4.		
5.		

Indicate whether procedure is good or weak internal control.

E7.6 (LO 1, 2) Listed below are five procedures followed by Rhone Bakery.

1. Employees are required to take vacations.
2. Any member of the sales department can approve credit sales.
3. Paul Jaggard ships goods to customers, bills customers, and receives payment from customers.
4. Total cash receipts are compared to bank deposits daily by someone who has no other cash responsibilities.
5. Time clocks are used for recording time worked by employees.

Instructions

Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principle is violated. Use the table below.

Procedure	IC Good or Weak?	Related Internal Control Principle
1.		
2.		
3.		
4.		
5.		

Prepare journal entries for a petty cash fund.

E7.7 (LO 2) Setterstrom Company established a petty cash fund on May 1, cashing a check for $100. The company reimbursed the fund on June 1 and July 1 with the following results.

June 1: Cash in fund $1.75. Receipts: delivery expense $31.25, postage expense $39.00, and miscellaneous expense $25.00.

July 1: Cash in fund $3.25. Receipts: delivery expense $21.00, entertainment expense $51.00, and miscellaneous expense $24.75.

On July 10, Setterstrom increased the fund from $100 to $130.

Instructions

Prepare journal entries for Setterstrom Company for May 1, June 1, July 1, and July 10.

Prepare journal entries for a petty cash fund.

E7.8 (LO 2) Horvath Furniture uses an imprest petty cash system. The fund was established on March 1 with a balance of €100. During March, the following petty cash receipts were found in the petty cash box.

Date	Receipt No.	For	Amount
3/5	1	Stamp Inventory	€39
7	2	Freight-Out	21

Date	Receipt No.	For	Amount
9	3	Miscellaneous Expense	6
11	4	Travel Expense	24
14	5	Miscellaneous Expense	5

The fund was replenished on March 15 when the fund contained €2 in cash. On March 20, the amount in the fund was increased to €175.

Instructions

Journalize the entries in March that pertain to the operation of the petty cash fund.

Prepare bank reconciliation and adjusting entries.

E7.9 (LO 3) Wyatt Ltd. is unable to reconcile the bank balance at January 31. Wyatt's reconciliation is as follows.

Cash balance per bank	£3,560.20
Add: NSF check	490.00
Less: Bank service charge	25.00
Adjusted balance per bank	£4,025.20

Cash balance per books	£3,875.20
Less: Deposits in transit	530.00
Add: Outstanding checks	730.00
Adjusted balance per books	£4,075.20

Instructions

a. Prepare a correct bank reconciliation.

b. Journalize the entries required by the reconciliation.

Determine outstanding checks.

E7.10 (LO 3) On April 30, the bank reconciliation of Westbrook Company shows three outstanding checks: no. 254, $650; no. 255, $620; and no. 257, $410. The May bank statement and the May cash payments journal show the following.

Bank Statement
Checks Paid

Date	Check No.	Amount
5/4	254	$650
5/2	257	410
5/17	258	159
5/12	259	275
5/20	261	500
5/29	263	480
5/30	262	750

Cash Payments Journal
Checks Issued

Date	Check No.	Amount
5/2	258	$159
5/5	259	275
5/10	260	890
5/15	261	500
5/22	262	750
5/24	263	480
5/29	264	560

Instructions

Using Step 2 in the reconciliation procedure, list the outstanding checks at May 31.

Prepare bank reconciliation and adjusting entries.

E7.11 (LO 3) The following information pertains to Crane Video (amounts in thousands).

1. Cash balance per bank, July 31, HK$7,263.
2. July bank service charge not recorded by the depositor HK$28.
3. Cash balance per books, July 31, HK$7,284.
4. Deposits in transit, July 31, HK$1,300.
5. Bank collected HK$700 note for Crane in July, plus interest HK$36, less fee HK$20. The collection has not been recorded by Crane, and no interest has been accrued.
6. Outstanding checks, July 31, HK$591.

Instructions

a. Prepare a bank reconciliation at July 31.

b. Journalize the adjusting entries at July 31 on the books of Crane Video.

Prepare bank reconciliation and adjusting entries.

E7.12 (LO 3) The information below relates to the Cash account in the ledger of Wang Artworks (amounts in thousands).

Balance September 1—¥17,150; Cash deposited—¥64,000.

Balance September 30—¥17,404; Checks written—¥63,746.

The September bank statement shows a balance of ¥16,422 on September 30 and the following memoranda.

Credits		Debits	
Collection of ¥2,500 note plus interest ¥30	¥2,530	NSF check: Richard Nance	¥425
Interest earned on checking account	¥45	Safety deposit box rent	¥65

At September 30, deposits in transit were ¥5,450, and outstanding checks totaled ¥2,383.

Instructions

a. Prepare the bank reconciliation at September 30.

b. Prepare the adjusting entries at September 30, assuming (1) the NSF check was from a customer on account, and (2) no interest had been accrued on the note.

Compute deposits in transit and outstanding checks for two bank reconciliations.

E7.13 (LO 3) The cash records of Dawes Ceramics show the following four situations.

For July:

1. The June 30 bank reconciliation indicated that deposits in transit total €920. During July, the general ledger account Cash shows deposits of €15,750, but the bank statement indicates that only €15,600 in deposits were received during the month.
2. The June 30 bank reconciliation also reported outstanding checks of €680. During the month of July, Dawes Ceramics' books show that €17,200 of checks were issued. The bank statement showed that €16,400 of checks cleared the bank in July.

For September:

3. In September, deposits per the bank statement totaled €26,700, deposits per books were €26,400, and deposits in transit at September 30 were €2,100.

4. In September, cash disbursements per books were €23,700, checks clearing the bank were €25,000, and outstanding checks at September 30 were €2,100.

There were no bank debit or credit memoranda. No errors were made by either the bank or Dawes Ceramics.

Instructions

Answer the following questions.

a. In situation (1), what were the deposits in transit at July 31?

b. In situation (2), what were the outstanding checks at July 31?

c. In situation (3), what were the deposits in transit at August 31?

d. In situation (4), what were the outstanding checks at August 31?

Show presentation of cash in financial statements.

E7.14 (LO 4) Kaur Artisans has recorded the following items in its financial records (amounts in thousands).

Cash in bank	42,000
Cash in plant expansion fund	100,000
Cash on hand	12,000
Highly liquid investments	34,000
Petty cash	500
Receivables from customers	89,000
Debt investments	61,000

The highly liquid investments had maturities of 3 months or less when they were purchased. The debt investments will be sold in the next 6 to 12 months. The plant expansion project will begin in 3 years.

Instructions

a. What amount should Kaur report as "Cash and cash equivalents" on its statement of financial position?

b. Where should the items not included in part (a) be reported on the statement of financial position?

Identify reporting of cash.

E7.15 (LO 4) A new accountant at Wyne Glass is trying to identify which of the amounts shown below should be reported as part of the current asset "Cash and cash equivalents" in the year-end statement of financial position, as of April 30, 2025.

1. $60 of currency and coin in a locked box used for incidental cash transactions.
2. $260 of April-dated checks that Wyne has received from customers but not yet deposited.
3. An $85 check received from a customer in payment of its April account, but postdated to May 1.
4. $2,500 in the company's checking account.
5. $4,800 in its savings account.
6. $75 of prepaid postage in its postage meter.
7. A $25 IOU from the company receptionist.

Instructions

a. What balance should Wyne report as its "Cash and cash equivalents" balance at April 30, 2025?

b. In what account(s) and in what financial statement(s) should the items not included in "Cash and cash equivalents" be reported?

Problems

Identify internal control principles over cash disbursements.

P7.1 (LO 1, 2) Bolz Office Supply recently changed its system of internal control over cash disbursements. The system includes the following features.

Instead of being unnumbered and manually prepared, all checks must now be prenumbered and prepared by using the new accounts payable software purchased by the company. Before a check can be issued, each invoice must have the approval of Kathy Moon, the purchasing agent, and Robin Self, the receiving department supervisor. Checks must be signed by either Jennifer Edwards, the treasurer, or Rich Woodruff, the assistant treasurer. Before signing a check, the signer is expected to compare the amount of the check with the amount on the invoice.

After signing a check, the signer stamps the invoice PAID and inserts the date, check number, and amount of the check within the stamp. The "paid" invoice is then sent to the accounting department for recording.

Blank checks are stored in a safe in the treasurer's office. The combination to the safe is known only by the treasurer and assistant treasurer. Each month, the bank statement is reconciled with the bank balance per books by the assistant chief accountant. All employees who handle or account for cash are bonded.

Instructions

Identify the internal control principles and their application to cash disbursements of Bolz Office Supply.

Identify internal control weaknesses in cash receipts and cash disbursements.

P7.2 (LO 1, 2) Rondelli School wants to raise money for a new sound system for its auditorium. The primary fund-raising event is a dance at which the famous disc jockey D.J. Sound will play classic and not-so-classic dance tunes. Matt Ballester, the music and theater instructor, has been given the responsibility for coordinating the fund-raising efforts. This is Matt's first experience with fund-raising. He decides to put the student choir in charge of the event; he will be a relatively passive observer.

Matt had 500 unnumbered tickets printed for the dance. He left the tickets in a box on his desk and told the choir students to take as many tickets as they thought they could sell for €5 each. In order to ensure that no extra tickets would be floating around, he told them to dispose of any unsold tickets. When the students received payment for the tickets, they were to bring the cash back to Matt and he would put it in a locked box in his desk drawer.

Some of the students were responsible for decorating the gymnasium for the dance. Matt gave each of them a key to the money box and told them that if they took money out to purchase materials, they should put a note in the box saying how much they took and what it was used for. After 2 weeks the money box appeared to be getting full, so Matt asked Jeff Kenney to count the money, prepare a deposit slip, and deposit the money in a bank account Matt had opened.

The day of the dance, Matt wrote a check from the account to pay the DJ. D.J. Sound, however, said that he accepted only cash and did not give receipts. So Matt took €200 out of the cash box and gave it to D.J. At the dance, Matt had Sam Copper working at the entrance to the gymnasium, collecting tickets from students, and selling tickets to those who had not prepurchased them. Matt estimated that 400 students attended the dance.

The following day, Matt closed out the bank account, which had €250 in it, and gave that amount plus the €180 in the cash box to Principal Finke. Principal Finke seemed surprised that, after

generating roughly €2,000 in sales, the dance netted only €430 in cash. Matt did not know how to respond.

Instructions

Identify as many internal control weaknesses as you can in this scenario, and suggest how each could be addressed.

Journalize and post petty cash fund transactions.

P7.3 (LO 2) Kael Photography maintains a petty cash fund for small expenditures. These transactions occurred during the month of August.

Aug. 1	Established the petty cash fund by writing a check payable to the petty cash custodian for R$200.
15	Replenished the petty cash fund by writing a check for R$175. On this date, the fund consisted of R$25 in cash and these petty cash receipts: freight-out R$74.40, entertainment expense R$36, postage expense R$33.70, and miscellaneous expense R$27.50.
16	Increased the amount of the petty cash fund to R$400 by writing a check for R$200.
31	Replenished the petty cash fund by writing a check for R$283. On this date, the fund consisted of R$117 in cash and these petty cash receipts: postage expense R$145, entertainment expense R$90.60, and freight-out R$46.40.

Instructions

a. Journalize the petty cash transactions.

b. Post to the Petty Cash account.

c. What internal control features exist in a petty cash fund?

Prepare a bank reconciliation and adjusting entries.

P7.4 (LO 3) On July 31, 2025, Keeds Company had a cash balance per books of $6,140. The statement from Dakota State Bank on that date showed a balance of $7,690.80. A comparison of the bank statement with the Cash account revealed the following facts.

1. The bank service charge for July was $25.
2. The bank collected $1,520 for Keeds Company through electronic funds transfer.
3. The July 31 receipts of $1,193.30 were not included in the bank deposits for July. These receipts were deposited by the company in a night deposit vault on July 31.
4. Company check No. 2480 issued to L. Taylor, a creditor, for $384 that cleared the bank in July was incorrectly entered as a cash payment on July 10 for $348.
5. Checks outstanding on July 31 totaled $1,860.10.
6. On July 31, the bank statement showed an NSF charge of $575 for a check received by the company from W. Krueger, a customer, on account.

Instructions

a. Prepare the bank reconciliation as of July 31.

a. Adjusted cash bal. $7,024.00

b. Prepare the necessary adjusting entries at July 31.

Prepare a bank reconciliation and adjusting entries from detailed data.

P7.5 (LO 3) The bank portion of the bank reconciliation for Shou Florists at November 30, 2025, was as follows (amounts in thousands).

Shou Florists
Bank Reconciliation
November 30, 2025

Cash balance per bank		HK$14,367.90
Add: Deposits in transit		2,530.20
		16,898.10
Less: Outstanding checks		
Check Number	Check Amount	
3451	HK$2,260.40	
3470	720.10	
3471	844.50	
3472	1,426.80	
3474	1,050.00	6,301.80
Adjusted cash balance per bank		HK$10,596.30

The adjusted cash balance per bank agreed with the cash balance per books at November 30.

The December bank statement showed the following checks and deposits.

Bank Statement

Checks			**Deposits**	
Date	**Number**	**Amount**	**Date**	**Amount**
12-1	3451	HK$ 2,260.40	12-1	HK$ 2,530.20
12-2	3471	844.50	12-4	1,211.60
12-7	3472	1,426.80	12-8	2,365.10
12-4	3475	1,640.70	12-16	2,672.70
12-8	3476	1,300.00	12-21	2,945.00
12-10	3477	2,130.00	12-26	2,567.30
12-15	3479	3,080.00	12-29	2,836.00
12-27	3480	600.00	12-30	1,025.00
12-30	3482	475.50	Total	HK$18,152.90
12-29	3483	1,140.00		
12-31	3485	540.80		
	Total	HK$15,438.70		

The cash records per books for December showed the following.

Cash Payments Journal

Date	Number	Amount	Date	Number	Amount
12-1	3475	HK$1,640.70	12-20	3482	HK$ 475.50
12-2	3476	1,300.00	12-22	3483	1,140.00
12-2	3477	2,130.00	12-23	3484	798.00
12-4	3478	621.30	12-24	3485	450.80
12-8	3479	3,080.00	12-30	3486	889.50
12-10	3480	600.00	Total		HK$13,933.20
12-17	3481	807.40			

Cash Receipts Journal

Date	Amount
12-3	HK$ 1,211.60
12-7	2,365.10
12-15	2,672.70
12-20	2,954.00
12-25	2,567.30
12-28	2,836.00
12-30	1,025.00
12-31	1,690.40
Total	HK$17,322.10

The bank statement contained two memoranda:

1. A credit of HK$2,242 for the collection of Shou Florists of an electronic funds transfer.
2. A debit for the printing of additional company checks HK$85.

At December 31, the cash balance per books was HK$13,985.20, and the cash balance per the bank statement was HK$19,239.10. The bank did not make any errors, but **Shou Floristsmade two errors**.

Instructions

a. Using the steps in the reconciliation procedure described in the chapter, prepare a bank reconciliation at December 31, 2025.

a. Adjusted balance per books HK$16,043.20

b. Prepare the adjusting entries based on the reconciliation. (*Hint:* The correction of any errors pertaining to recording checks should be made to Accounts Payable. The correction of any errors relating to recording cash receipts should be made to Accounts Receivable.)

Prepare a bank reconciliation and adjusting entries.

P7.6 (LO 3) Timmins Grow-Fast spreads herbicides and applies liquid fertilizer for local farmers. On May 31, 2025, the company's Cash account per its general ledger showed a balance of £6,738.90.

The bank statement from Manchester Bank on that date showed the following balance.

MANCHESTER BANK

Checks and Debits	Deposits and Credits	Daily Balance
		5-31 6,968.00

A comparison of the details on the bank statement with the details in the Cash account revealed the following facts.

1. The statement included a debit memo of £40 for the printing of additional company checks.
2. Cash sales of £883.15 on May 12 were deposited in the bank. The cash receipts entry and the deposit slip were incorrectly made for £933.15. The bank credited Timmins for the correct amount.
3. Outstanding checks at May 31 totaled £276.25, and deposits in transit were £1,880.15.
4. On May 18, the company issued check No. 1181 for £685 to H. Moses, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Timmins for £658.
5. £2,690 was collected from a customer's note receivable by the bank for Timmins on May 31 through electronic funds transfer.
6. Included with the canceled checks was a check issued by Tomins to C. Pernod for £360 that was incorrectly charged to Timmins by the bank.
7. On May 31, the bank statement showed an NSF charge of £380 for a check issued by Sara Ballard, a customer, to Timmins on account.

Instructions

a. Prepare the bank reconciliation at May 31, 2025.

a. Adjusted cash bal. £8,931.90

b. Prepare the necessary adjusting entries for Timmins at May 31, 2025.

Prepare a comprehensive bank reconciliation with theft and internal control deficiencies.

P7.7 (LO 1, 2, 3) Daisey Company is a very profitable small business. It has not, however, given much consideration to internal control. For example, in an attempt to keep clerical and office expenses to a minimum, the company has combined the jobs of cashier and bookkeeper. As a result, Bret Turrin handles all cash receipts, keeps the accounting records, and prepares the monthly bank reconciliations.

The balance per the bank statement on October 31, 2025, was $18,380. Outstanding checks were No. 62 for $140.75, No. 183 for $180, No. 284 for $253.25, No. 862 for $190.71, No. 863 for $226.80, and No. 864 for $165.28. Included with the statement was a credit memorandum of $185 indicating the collection of a note receivable for Daisey Company by the bank on October 25. This memorandum has not been recorded by Daisey.

The company's ledger showed one Cash account with a balance of $21,877.72. The balance included undeposited cash on hand. Because of the lack of internal controls, Bret took for personal use all of the undeposited receipts in excess of $3,795.51. He then prepared the following bank reconciliation in an effort to conceal his theft of cash.

Cash balance per books, October 31		$21,877.72
Add: Outstanding checks		
No. 862	$190.71	
No. 863	226.80	
No. 864	165.28	482.79
		22,360.51
Less: Undeposited receipts		3,795.51
Unadjusted balance per bank, October 31		18,565.00
Less: Bank credit memorandum		185.00
Cash balance per bank statement, October 31		$18,380.00

Instructions

a. Prepare a correct bank reconciliation. (*Hint:* Deduct the amount of the theft from the adjusted balance per books.)

a. Adjusted cash bal.$21,018.72

b. Indicate the three ways that Bret attempted to conceal the theft and the dollar amount involved in each method.

c. What principles of internal control were violated in this case?

Comprehensive Accounting Cycle Review

ACR7 On December 1, 2025, Papadopoulos Seasonings had the following account balances.

	Debit		Credit
Cash	€18,200	Accumulated Depreciation—	
Notes Receivable	2,200	Equipment	€ 3,000
Accounts Receivable	7,500	Accounts Payable	6,100
Inventory	16,000	Share Capital—Ordinary	50,000
Prepaid Insurance	1,600	Retained Earnings	14,400
Equipment	28,000		€73,500
	€73,500		

During December, the company completed the following transactions.

Dec. 7 Received €3,600 cash from customers in payment of account (no discount allowed).

12 Purchased merchandise on account from Spiro Co. €12,000, terms 1/10, n/30.

17 Sold merchandise on account €16,000, terms 2/10, n/30. The cost of the merchandise sold was €10,000.

19 Paid salaries €2,200.

22 Paid Spiro Co. in full, less discount.

26 Received collections in full, less discounts, from customers billed on December 17.

31 Received €2,700 cash from customers in payment of account (no discount allowed).

Adjustment data:

1. Depreciation €200 per month.
2. Insurance expired €400.

Instructions

a. Journalize the December transactions. (Assume a perpetual inventory system.)

b. Enter the December 1 balances in the ledger T-accounts and post the December transactions. Use Cost of Goods Sold, Depreciation Expense, Insurance Expense, Salaries and Wages Expense, Sales Revenue, and Sales Discounts.

c. The statement from Athens Bank on December 31 showed a balance of €26,130. A comparison of the bank statement with the Cash account revealed the following facts.

1. The bank collected a note receivable of €2,200 for Papadopoulos on December 15.
2. The December 31 receipts were deposited in a night deposit vault on December 31. These deposits were recorded by the bank in January.
3. Checks outstanding on December 31 totaled €1,210.
4. On December 31, the bank statement showed an NSF charge of €680 for a check received by the company from A. Quinn, a customer, on account.

   Prepare a bank reconciliation as of December 31 based on the available information. (*Hint:* The cash balance per books is €26,100. This can be proven by finding the balance in the Cash account from parts (a) and (b).)

d. Journalize the adjusting entries resulting from the bank reconciliation and adjustment data.

e. Post the adjusting entries to the ledger T-accounts.

f. Prepare an adjusted trial balance.

   f. Adj. cash balance €27,620

g. Prepare an income statement for December and a classified statement of financial position at December 31.

   g. Net income €2,880

Data Analytics in Action

Using Data Visualization to Understand Fraud

DA7.1 Data visualization can be used to identify the occurrence of behavioral red flags.



Example: Most people who commit fraud leave clues, called red flags, that call attention to their actions. Sometimes, more than one red flag exists. Rarely, there are none.

Many of the red flags have common characteristics and can be divided into groups. For example, consider the following chart. Do you notice that several red flags are related to finances, while other red flags appear to have social and emotional ties? Both groups are tied to the pressure component of the fraud triangle, which will lead people to consider committing fraud.

Unfortunately, even with 85% of incidents showing red flags (as noted in the chart, 15% of frauds indicated no red flags), much of the fraudulent activity is not identified until a loss has occurred. Nonetheless, it is important for managers to look out for red flags to help identify fraud situations as soon as possible.

For this case, you will use data that show internal controls in place and the impact on reducing the cost to the organization of the fraud. You will create a combo clustered column and line chart and then analyze it to determine which internal controls reduced the loss by the greatest percentage.

Go to the Wiley online course for complete case details and instructions.

Using Data Analytics to Determine the Impact of Internal Control Activities



DA7.2 Fraud not only costs an organization money but also time. For this case, you will use data that provides the percentage reduction of time and percent reduction of loss for various internal control activities. You will create and analyze a column chart to identify the controls that are most effective in reducing time and fraud.

Go to the Wiley online course for complete case details and instructions.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT7.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

a. What data about cash and cash equivalents are shown in the consolidated statement of financial position?

b. In its notes to Consolidated Financial Statements, how does TSMC define cash equivalents?

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT7.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information contained in these financial statements, determine each of the following for each company:

1. Cash and cash equivalents balance at December 31, 2020.
2. Cash provided by operating activities during the year ended December 2020 (from statement of cash flows).

b. What conclusions concerning the management of cash can be drawn from these data?

Real-World Focus

CT7.3 Every two years, the **Association of Certified Fraud Examiners (ACFE)** produces a report called the "Report to the Nations" that provides a summary of recent fraud cases. The report is available at no cost on its website.

Instructions

Search for this report and read over the summary provided at the beginning of the report. The summary has different names but is usually called "Key Findings" or "Executive Summary." After you have read the summary, answer the following questions.

a. What does fraud cost businesses?

b. What are the most common types of fraud?

c. What is the most common method to detect fraud, and what can businesses do to make fraud detection more likely?

CT7.4 While blockchain technology is currently costly and complex, it has numerous potential benefits to improve internal control. An article by Ken Tysiac in the *Journal of Accountancy* entitled "Evaluating Blockchain and Internal Control Through a COSO Lens" discusses these potential benefits.

Instructions

Search online for the article and then describe the potential benefits of blockchain for each of the five primary components of internal control: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

CT7.5 The **International Accounting Standards Board (IASB)** is a private organization established to develop a single set of high-quality, understandable, enforceable, and globally

accepted financial reporting standards. The IASB conducts extensive research before issuing a new standard or amending an existing standard.

Instructions

Go to the IASB website to answer the following questions.

a. What are the important steps of the standard-setting process?

b. After a standard is issued, what steps does the IASB take to ensure that the standard is achieving its objective?

Decision-Making Across the Organization

CT7.6 The board of trustees of a local church is concerned about the internal accounting controls for the offering collections made at weekly services. The trustees ask you to serve on a three-person audit team with the internal auditor of a local college and a public accountant who has just joined the church.

At a meeting of the audit team and the board of trustees, you learn the following.

1. The church's board of trustees has delegated responsibility for the financial management and audit of the financial records to the finance committee. This group prepares the annual budget and approves major disbursements. It is not involved in collections or recordkeeping. No audit has been made in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years. The church does not carry any fidelity insurance.
2. The collection at the weekly service is taken by a team of ushers who volunteer to serve one month. The ushers take the collection plates to a basement office at the rear of the church. They hand their plates to the head usher and return to the church service. After all plates have been turned in, the head usher counts the cash received. The head usher then places the cash in the church safe along with a notation of the amount counted. The head usher volunteers to serve for 3 months.
3. The next morning, the financial secretary opens the safe and recounts the collection. The secretary withholds £150–£200 in cash, depending on the cash expenditures expected for the week, and deposits the remainder of the collections in the bank. To facilitate the deposit, church members who contribute by check are asked to make their checks payable to "Cash."
4. Each month, the financial secretary reconciles the bank statement and submits a copy of the reconciliation to the board of trustees. The reconciliations have rarely contained any bank errors and have never shown any errors per books.

Instructions

With the class divided into groups, answer the following.

a. Indicate the weaknesses in internal accounting control over the handling of collections.

b. List the improvements in internal control procedures that you plan to make at the next meeting of the audit team for (1) the ushers, (2) the head usher, (3) the financial secretary, and (4) the finance committee.

c. What church policies should be changed to improve internal control?

Ethics Case

CT7.7 You are the assistant controller in charge of general ledger accounting at Hallasan Bottling. Your company has a large loan from an insurance company. The loan agreement requires that the company's cash account balance be maintained at ₩200,000 or more, as reported monthly (amounts in thousands).

At June 30, the cash balance is ₩80,000, which you report to Yoo Yun, the financial vice president. Yoo excitedly instructs you to keep the cash receipts book open for one additional day for purposes

of the June 30 report to the insurance company. Yoo says, "If we don't get that cash balance over ₩200,000, we'll default on our loan agreement. They could close us down, put us all out of our jobs!" Yoo continues, "I talked to Oconto Distributors (one of Hallasan's largest customers) this morning. They said they sent us a check for ₩150,000 yesterday. We should receive it tomorrow. If we include just that one check in our cash balance, we'll be in the clear. It's in the mail!"

Instructions

a. Who will suffer negative effects if you do not comply with Yoo's instructions? Who will suffer if you do comply?

b. What are the ethical considerations in this case?

c. What alternatives do you have?

A Look at U.S. GAAP

> **LEARNING OBJECTIVE 5**
>
> Compare the accounting for fraud, internal control, and cash under IFRS and U.S. GAAP.

Fraud can occur anywhere. And because the three main factors that contribute to fraud are universal in nature, the principles of internal control activities are used globally by companies. GAAP and IFRS are also very similar in accounting for cash. *IAS No. 1 (revised)*, "Presentation of Financial Statements," is the only standard that discusses issues specifically related to cash.

Key Points

- The fraud triangle discussed in this chapter is applicable to all international companies. Some of the major frauds on a U.S. basis are **Enron** (USA), **WorldCom** (USA), and more recently the Bernie Madoff Ponzi scheme.
- Internal controls are a system of checks and balances designed to prevent and detect fraud and errors. While most companies have these systems in place, many have never completely documented them, nor had an independent auditor attest to their effectiveness.
- Companies find that internal control review is a costly process but badly needed. One study estimates the cost to U.S. companies at over $35 billion. At the same time, examination of internal controls indicates lingering problems in the way companies operate.

Similarities

- Accounting scandals both in the United States and internationally have re-ignited the debate over the relative merits of GAAP, which takes a "rules-based" approach to accounting, versus IFRS, which takes a "principles-based" approach. The FASB announced that it intends to introduce more principles-based standards.
- The accounting and internal control procedures related to cash are essentially the same under both GAAP and this text. In addition, the definition used for cash equivalents is the same.
- Most companies report cash and cash equivalents together under GAAP, as shown in this text. In addition, GAAP follows the same accounting policies related to the reporting of restricted cash.
- GAAP and IFRS define cash and cash equivalents similarly as follows.
  - **Cash** is comprised of cash on hand and demand deposits.
  - **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Differences

- After numerous company scandals, the U.S. Congress passed the Sarbanes-Oxley Act (SOX). Under SOX, all publicly traded U.S. corporations are required to maintain an adequate system of internal control.
- As a result of SOX, company executives and boards of directors must ensure that internal controls are reliable and effective. In addition, independent outside auditors must attest to the adequacy of the internal control system.
- SOX created the Public Company Accounting Oversight Board (PCAOB) to establish auditing standards and regulate auditor activity.

GAAP Practice

GAAP Self-Test Questions

1. Non-U.S. companies that follow IFRS:

a. do not normally use the principles of internal control activities described in this text.

b. often offset cash with accounts payable on the statement of financial position.

c. are not required to follow SOX.

d. None of the answer choices is correct.

Answer

2. Which of the following is the correct accounting under GAAP for cash?

a. Cash cannot be combined with cash equivalents.

b. Demand deposits are not included as cash.

c. Cash equivalents are short-term, highly liquid investments that can be converted into known amounts of cash and are so near maturity that their market value is not generally sensitive to interest rate changes.

d. Cash on hand is not reported on the statement of financial position as Cash.

Answer

3. The Sarbanes-Oxley Act applies to:

a. all U.S. companies listed on U.S. exchanges.

b. all companies that list shares on any securities exchange in any country.

c. all European companies listed on European exchanges.

d. Both U.S. companies listed on U.S. exchanges and European companies listed on European exchanges.

Answer

4. High-quality accounting requires both high-quality accounting standards and:

a. a reconsideration of SOX to make it less onerous.

b. high-quality auditing standards.

c. government intervention to ensure that the public interest is protected.

d. the development of new principles of internal control activities.

Answer

5. Cash equivalents under GAAP:

a. are significantly different than the cash equivalents discussed in the text.

b. are generally disclosed separately from cash.

c. may be required to be reported separately from cash in the future.

d. None of the answer choices is correct.

Answer

GAAP Exercises

GAAP7.1 Some people argue that the internal control requirements of the Sarbanes-Oxley Act (SOX) put U.S. companies at a competitive disadvantage to companies outside the United States. Discuss the competitive implications (both pros and cons) of SOX.

GAAP7.2 State whether each of the following is true or false. For those that are false, explain why.

a. A proposed new financial accounting standard would not allow cash equivalents to be reported in combination with cash.

b. Perspectives on bribery and penalties for engaging in bribery are the same across all countries.

c. Cash equivalents are comprised of cash on hand and demand deposits.

d. SOX was created by the International Accounting Standards Board.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP7.3 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Using the financial statements and notes to the financial statements, answer these questions about Apple's internal controls and cash.

a. What comments, if any, are made about cash in the "Report of Independent Registered Public Accounting Firm"?

b. What data about cash and cash equivalents are shown in the consolidated balance sheet (statement of financial position)?

c. How are cash equivalents defined in the Notes to Consolidated Financial Statements?

d. Read the section of the report titled "Management's Report on Internal Control Over Financial Reporting." Summarize the statements made in that section of the report.

Note

1 Stephan J. McNally, "The 2013 COSO Framework and SOX Compliance," *Strategic Finance* (June 2013). The COSO definition of internal control is widely accepted around the world. See, for example, OECD, "Internal Control and Internal Audit: Ensuring Public Sector Integrity and Accountability" (April 2011).

2 We explain the operation of a petty cash fund in the next section.

3 The term "imprest" means an advance of money for a designated purpose.

4 Our presentation assumes that a company makes all adjustments at the end of the month. In practice, a company may also make journal entries during the month as it reviews information from the bank regarding its account.

CHAPTER 8
Accounting for Receivables



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Chapter Preview

As indicated in the following Feature Story, receivables are a significant asset for many banks. Because a large portion of sales are credit sales, receivables are important to companies in other industries as well. As a consequence, companies must pay close attention to their receivables and manage them carefully. In this chapter, you will learn what journal entries companies make when they sell products, when they collect cash from those sales, and when they write off accounts they cannot collect.

Feature Story

Are You Going to Pay Me—or Not?

What is the only thing harder than making a sale? Answer: Collecting the cash. Just ask a banker, virtually any banker. Bankers around the world have been awash in "doubtful" loans for years. And, it may be many years before the mess is finally cleaned up.

If your business sells most of its goods on credit or is in the business of making loans, then accurately recording your receivables is one of your most important accounting tasks. At the end of every accounting period, companies are required to estimate how many of their receivables are "uncollectible." A significant decline in the amount of estimated doubtful loans can send a company's share price soaring. For example, **BNP Paribas** (FRA) reported a decline in the estimated provision for doubtful loans of more than 50%. The market reacted very favorably, with the company's share price rising by 5.3% in one day.

On the other hand, when a company announces an unexpected increase in its estimated doubtful loans, the securities market often reacts severely. For example, **BBVA** (ESP) announced that it was increasing its estimated provision for doubtful loans by €164 million. Its share price fell by 6% in a single day.

No bank is spared scrutiny of its estimated doubtful loans. In fact, it is likely that no number in a bank's financial statements receives more careful investigation by financial analysts and investors. Nearly three years after the beginning of the financial crisis, **Bank of America**'s (USA) share price was still in single digits (after hitting a high of $54 per share) primarily because of investor concern regarding its provision for doubtful loans. And, on the other side of the globe, in Iran, one banker suggested that as many as 20% of the loans held by that country's banks are doubtful.

Sources: Ben Hall, "Fall in Bad Loans Boosts BNP Paribas," *Financial Times Online* (August 2, 2010); Tracy Alloway, "BBVA, An Exercise in Spanish Banking Losses," *Financial Times Online* (February 3, 2011); and Najmeh Bozorgmehr, "Private Banks Open to Assist Tehran Insiders," *Financial Times Online* (May 9, 2011).

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Explain how companies recognize accounts receivable.	• Types of receivables • Recognizing accounts receivable	DO IT! 1 Recognizing Accounts Receivable
LO 2 Describe how companies value accounts receivable and record their disposition.	• Valuing accounts receivable • Disposing of accounts receivable	DO IT! 2a Bad Debt Expense 2b Factoring
LO 3 Explain how companies recognize, value, and dispose of notes receivable.	• Determining the maturity date • Computing interest • Recognizing notes receivable • Valuing notes receivable • Disposing of notes receivable	DO IT! 3 Recognizing Notes Receivable
LO 4 Describe the statement presentation and analysis of receivables.	• Presentation • Analysis • Data analytics and receivables management	DO IT! 4 Analysis of Receivables

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions. Additional tutorials and practice opportunities are available in the Wiley online course.

8.1 Recognition of Accounts Receivable

> **LEARNING OBJECTIVE 1**
>
> Explain how companies recognize accounts receivable.

The term **receivables** refers to amounts due from individuals and companies.

- Receivables are claims that are expected to be collected in cash.
- The management of receivables is a very important activity for any company that sells goods or services on credit.

Receivables are important because they represent one of a company's most liquid assets. For many companies, receivables are also one of the largest assets. For example, receivables represent 43.7% of the current assets of telecommunications giant **Etisalat** (UAE). **Illustration 8.1** lists receivables as a percentage of total assets for five other well-known companies in a recent year.

ILLUSTRATION 8.1 Receivables as a percentage of assets

Company	Receivables as a Percentage of Total Assets
adidas (DEU)	9%
Hyundai (KOR)	3
Samsung (KOR)	9
Nestlé (CHE)	9
China Mobile Limited (HKG)	5

Types of Receivables

The relative significance of a company's receivables as a percentage of its assets depends on various factors: its industry, the time of year, whether it extends long-term financing, and its credit policies. To reflect important differences among receivables, they are frequently classified as (1) accounts receivable, (2) notes receivable, and (3) other receivables.

Accounts receivable are amounts customers owe on account. They result from the sale of goods and services. Companies generally expect to collect accounts receivable within 30 to 60 days. They are usually the most significant type of claim held by a company.

Notes receivable are a written promise (as evidenced by a formal instrument) for amounts to be received. The note normally requires the collection of interest and extends for time periods of 60–90 days or longer. Notes and accounts receivable that result from sales transactions are often called **trade receivables**.

Other receivables include non-trade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable (see **Ethics Note**). These do not generally result from the operations of the business. Therefore, they are generally classified and reported as separate items in the statement of financial position.

> **ETHICS NOTE**
>
> **Companies report receivables from employees separately in the financial statements. The reason: Sometimes these receivables are not the result of an "arm's-length" transaction.**

Recognizing Accounts Receivable

Recognizing accounts receivable is relatively straightforward.

- A service organization records a receivable when it performs service on account.
- A merchandiser records accounts receivable at the point of sale of merchandise on account. When a merchandiser sells goods, it increases (debits) Accounts Receivable and increases (credits) Sales Revenue.

Recall that sellers sometimes offer sales discounts to encourage early payment by the buyer. If the buyer pays during the discount period, the receivable balance will be satisfied with a smaller cash

payment. Also, the buyer might find some of the goods unacceptable and choose to return the unwanted goods. When a buyer returns goods that it previously purchased on credit, the receivable balance is reduced.

To review, assume that Zhang Ltd. on July 1, 2025, sells merchandise on account to Li Stores for ¥1,000, terms 2/10, n/30 (amounts in thousands). On July 5, Li returns merchandise with a sales price of ¥100 to Zhang. On July 11, Zhang receives payment from Li for the balance due. The journal entries to record these transactions on the books of Zhang are as follows (see **Helpful Hint**). **(Cost of goods sold entries are omitted.)**

> **HELPFUL HINT**
>
> **These entries are the same as those described in Chapter 5. For simplicity, we have omitted inventory and cost of goods sold from this set of journal entries and from end-of-chapter material.**

July 1	Accounts Receivable	1,000	
	Sales Revenue		1,000
	(To record sales on account)		
July 5	Sales Returns and Allowances	100	
	Accounts Receivable		100
	(To record merchandise returned)		
July 11	Cash (¥900 – ¥18)	882	
	Sales Discounts (¥900 × .02)	18	
	Accounts Receivable		900
	(To record collection of accounts receivable)		

Some retailers issue their own credit cards. When you use a retailer's credit card (**IKEA** (SWE), for example), the retailer charges interest on the balance due if not paid within a specified period (usually 25–30 days).

To illustrate, assume that you use your IKEA credit card to purchase clothing with a sales price of €300 on June 1, 2025. IKEA will increase (debit) Accounts Receivable for €300 and increase (credit) Sales Revenue for €300 (cost of goods sold entry omitted) as follows.

June 1	Accounts Receivable	300	
	Sales Revenue		300
	(To record sale of merchandise)		

A	=	L	+	E
+300				+300 Rev

Cash Flows
no effect

Assuming that you owe €300 at the end of the month and IKEA charges 1.5% per month on the balance due, the adjusting entry that IKEA makes to record interest revenue of €4.50 (€300 × 1.5%) on June 30 is as follows.

June 30	Accounts Receivable	4.50	
	Interest Revenue		4.50
	(To record sale of merchandise)		

A	=	L	+	E
+4.50				+4.50 Rev

Cash Flows
no effect

Interest revenue is often substantial for many retailers.

Anatomy of a Fraud

Tasanee was the accounts receivable clerk for a large non-profit foundation that provided performance and exhibition space for the performing and visual arts. Her responsibilities included activities normally assigned to an accounts receivable clerk, such as recording revenues from various sources (donations, facility rental fees, and ticket revenue). However, she was also responsible for handling all cash and checks from the time they were received until the time she deposited them, as well as preparing the bank reconciliation.

Tasanee took advantage of her situation by falsifying bank deposits and bank reconciliations so that she could steal cash from the donations. Since nobody else logged the donations or matched the donation receipts to pledges prior to Tasanee receiving them, she was able to offset the cash that was stolen against donations that she received but didn't record. Her crime was made easier by the fact that her boss, the company's controller, only did a very superficial review of the bank reconciliation and thus didn't notice that some numbers had been cut out from other documents and taped onto the bank reconciliation.

Total take: $1.5 million

The Missing Controls

Segregation of duties. The foundation should not have allowed an accounts receivable clerk, whose job was to record receivables, to also handle cash, record cash, make deposits, and especially prepare the bank reconciliation.

Independent internal verification. The controller was supposed to perform a thorough review of the bank reconciliation. Because he did not, he was terminated from his position.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 183–194.

Data Analytics Insight



Andrey Popov/Adobe Stock

They've Got Your Number

Offering credit to customers has costs, as some credit customers will ultimately not be able to pay the amounts owed. Companies can minimize these costs by effectively analyzing data regarding current and potential customers.

Traditionally, companies based credit decisions on a limited number of factors, such as the customer's payment history, credit history, and debt to assets ratio. In contrast, credit-granting decisions using big data can take into account hundreds or even thousands of data points. These can even include the customer's social media network, spending habits, criminal history, and cell phone information. As the CEO of one online lender stated, "all data is credit data."

Data analytics can also be used in estimating uncollectible accounts and to minimize bad debts. For example, companies can use data analytics to determine the normal payment patterns of specific customers and then automatically generate phone calls whenever these customers deviate from their normal payment patterns. Resolving accounts receivable issues earlier increases the likelihood of their being resolved favorably.

Source: Adapted from Mikella Hurley and Julius Adebayo, "Credit Scoring in the Era of Big Data," *Yale Journal of Law and Technology*, Volume 18, Issue 1 (2017).

Why might a company want to consider a customer's social media network when deciding whether to grant the customer credit?

Answer

DO IT! 1

Recognizing Accounts Receivable

On May 1, Wilton sold merchandise on account to Bates for £50,000, terms 3/15, net 45. On May 4, Bates returns merchandise with a sales price of £2,000. On May 16, Wilton receives payment from Bates for the balance due. Prepare journal entries to record the May transactions on Wilton's books. (You may ignore cost of goods sold entries and explanations.)

ACTION PLAN

- **Familiarize yourself with each of the control activities.**
- **Understand the nature of the frauds that each control activity is intended to address.**

Solution

Related exercise material: **BE8.1**, **BE8.2**, **DO IT! 8.1**, **E8.1**, **E8.2**, **and E8.3**.

8.2 Valuation and Disposition of Accounts Receivable

> **LEARNING OBJECTIVE 2**
>
> Describe how companies value accounts receivable and record their disposition.

Valuing Accounts Receivable

Once companies record receivables in the accounts, the next question is: How should they report receivables in the financial statements? Companies report accounts receivable on the statement of financial position as an asset. But determining the **amount** to report is sometimes difficult because some receivables will become uncollectible.

Each customer must satisfy the credit requirements of the seller before the credit sale is approved. Inevitably, though, some accounts receivable become uncollectible. For example, a customer may not be able to pay because of a decline in its sales revenue due to a downturn in the economy. Similarly, individuals may be laid off from their jobs or faced with unexpected hospital bills.

- Companies record credit losses as **Bad Debt Expense** (or Uncollectible Accounts Expense) (see **Alternative Terminology**).
- Such losses are a normal and necessary risk of doing business on a credit basis.

> **ALTERNATIVE TERMINOLOGY**
>
> **You will sometimes see Bad Debt Expense called Uncollectible Accounts Expense.**

When the worldwide economy sharply contracted in the early months of the Covid-19 global pandemic, businesses closed. Many individuals either lost their jobs or had their incomes substantially reduced. As a result, many lenders experienced huge increases in their bad debt expense. For example, **Barclays plc** (GBR) increased its bad debt expense by over 250% from 2019 to 2020. During the same period, **CaixaBank SA** (ESP) increased its bad debt expense by over 450%.

Two methods are used in accounting for uncollectible accounts: (1) the direct write-off method and (2) the allowance method. The following sections explain these methods.

Direct Write-Off Method for Uncollectible Accounts

Under the **direct write-off method**, when a company determines a particular account to be uncollectible, it charges the loss to Bad Debt Expense. Assume, for example, that Warden Retail writes off as uncollectible M. E. Doran's NT$1,600 balance on December 12. Warden's entry is as follows.

Dec. 12	Bad Debt Expense	1,600	
	Accounts Receivable		1,600
	(To record write-off of M. E. Doran account)		

A	=	L	+	E
				−1,600 Exp
−1,600				

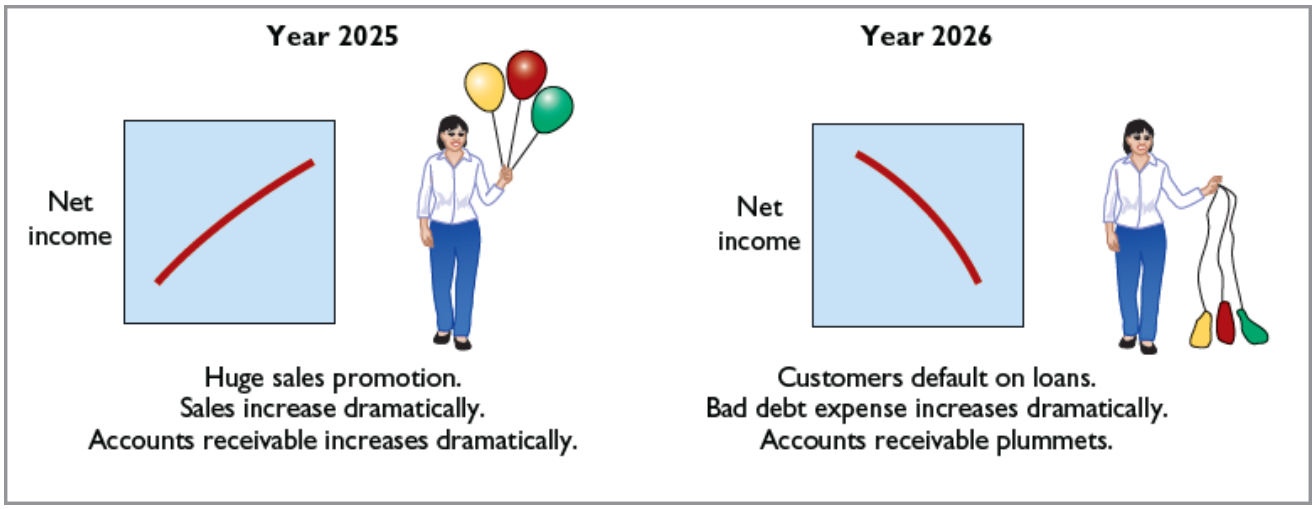
Cash Flows
no effect

Under this method, Bad Debt Expense will show only **actual losses** from uncollectibles. The company will report accounts receivable at its gross amount.

Use of the direct write-off method can reduce the relevance of both the income statement and the statement of financial position. Consider the following example. In 2025, Quick Buck Computers decided it could increase its revenues by offering computers to college students without requiring any money down and with no credit-approval process. It quickly sold one million computers with a selling price of HK$8,000 each. This increased Quick Buck's revenues and receivables by HK$8 billion.

The promotion was a huge success! The 2025 statement of financial position and income statement looked great. Unfortunately, during 2026, nearly 40% of the customers defaulted on their loans. This made the 2026 income statement and statement of financial position look terrible. **Illustration 8.2** shows the effect of these events on the financial statements if the direct write-off method is used.

ILLUSTRATION 8.2 Effects of direct write-off method



Under the direct write-off method, companies often record bad debt expense in a period different from the period in which they record the revenue. This is problematic for two reasons:

1. The method does not attempt to match bad debt expense to sales revenue in the income statement.
2. The direct write-off method does not show accounts receivable in the statement of financial position at the amount the company actually expects to receive.

Consequently, unless bad debt losses are insignificant, the direct write-off method is not acceptable for financial reporting purposes.

Allowance Method for Uncollectible Accounts

The **allowance method** of accounting for bad debts involves estimating uncollectible accounts at the end of each period. This provides better matching of expenses with revenues on the income statement. It also ensures that companies state receivables on the statement of financial position at their cash (net) realizable value.

- **Cash (net) realizable value** is the net amount the company expects to receive in cash.
- It excludes amounts that the company estimates it will not collect.

Thus, this method reduces receivables in the statement of financial position by the amount of estimated uncollectible receivables.

Companies must use the allowance method for financial reporting purposes when bad debts are material in amount (see **Helpful Hint**). This method has three essential features:

HELPFUL HINT

In this context, material means significant or important to financial statement users.

1. Companies **estimate** uncollectible accounts receivable. They match this estimated expense **against revenues** in the same accounting period in which they record the revenues.
2. Companies debit estimated uncollectibles to Bad Debt Expense and credit them to Allowance for Doubtful Accounts through an adjusting entry at the end of each period. Allowance for Doubtful Accounts is a contra account to Accounts Receivable.
3. When companies write off a specific account, they debit actual uncollectibles to Allowance for Doubtful Accounts and credit that amount to Accounts Receivable.

Recording Estimated Uncollectibles

To illustrate the allowance method, assume that Hampson Furniture has credit sales of €1,200,000 in 2025. Of this amount, €200,000 of receivables remains uncollected at December 31. The credit manager estimates that €12,000 of these receivables will be uncollectible. The adjusting entry to record the estimated uncollectibles increases (debits) Bad Debt Expense and increases (credits) Allowance for Doubtful Accounts, as follows.

Dec. 31	Bad Debt Expense	12,000	
	Allowance for Doubtful Accounts		12,000
	(To record estimate of uncollectible accounts)		

A	=	L	+	E
				−12,000 Exp
−12,000				

Cash Flows
no effect

Hampson reports Bad Debt Expense in the income statement as an operating expense. Thus, the estimated uncollectibles are matched with sales in 2025. Hampson records the expense in the same year it made the sales.

Allowance for Doubtful Accounts shows the estimated amount of claims on customers that the company expects will become uncollectible in the future.

- Companies use a contra account instead of a direct credit to Accounts Receivable because they do not know which customers will not pay.
- The credit balance in the allowance account will absorb the specific write-offs when they occur.

As Illustration 8.3 shows, the company deducts the allowance account from accounts receivable in the current assets section of the statement of financial position.

ILLUSTRATION 8.3 Presentation of allowance for doubtful accounts

Hampson Furniture Statement of Financial Position (partial)		
Current assets		
Supplies		€ 25,000
Inventory		310,000
Accounts receivable	**€200,000**	
Less: Allowance for doubtful accounts	**12,000**	**188,000**
Cash		14,800
Total current assets		€537,800

The amount of €188,000 in Illustration 8.3 represents the expected cash realizable value of the accounts receivable at the statement date (see **Helpful Hint**). **Companies do not close Allowance for Doubtful Accounts at the end of the fiscal year.**

> **HELPFUL HINT**
>
> **Cash realizable value is sometimes referred to as accounts receivable (net).**

Recording the Write-Off of an Uncollectible Account

Companies use various methods of collecting past-due accounts, such as letters, calls, and legal action. When they have exhausted all means of collecting a past-due account and collection appears impossible, the company writes off the account. In the credit card industry, for example, it is standard practice to write off accounts that are 210 days past due. To prevent premature or unauthorized write-offs, authorized management personnel should formally approve each write-off. **To maintain segregation of duties, the employee authorized to write off accounts should not have daily responsibilities related to cash or receivables.**

To illustrate a receivables write-off, assume that the financial vice president of Hampson Furniture authorizes a write-off of the €500 balance owed by R. A. Ware on March 1, 2026. The entry to record the write-off is as follows.

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable		500
	(Write-off of R. A. Ware account)		

A	=	L	+	E
+500 −500				
Cash Flows no effect				

The company does not increase bad debt expense when the write-off occurs.

- **Under the allowance method, companies debit every bad debt write-off to the allowance account rather than to Bad Debt Expense.**
- A debit to Bad Debt Expense would be incorrect because the company has already recognized the expense when it made the adjusting entry for estimated bad debts.

- Instead, the entry to record the write-off of an uncollectible account reduces both Accounts Receivable and Allowance for Doubtful Accounts.

After posting, the general ledger accounts appear as shown in Illustration 8.4.

ILLUSTRATION 8.4 General ledger balances after write-off

Accounts Receivable				Allowance for Doubtful Accounts			
Jan. 1 Bal.	200,000	Mar. 1	500	Mar. 1	500	Jan. 1 Bal.	12,000
Mar. 1 Bal.	199,500					Mar. 1 Bal.	11,500

A write-off affects **only statement of financial position accounts**—not income statement accounts. The write-off of the account reduces both Accounts Receivable and Allowance for Doubtful Accounts. Cash realizable value in the statement of financial position, therefore, remains the same, as Illustration 8.5 shows.

ILLUSTRATION 8.5 Cash realizable value comparison

	Before Write-Off	After Write-Off
Accounts receivable	€200,000	€199,500
Allowance for doubtful accounts	12,000	11,500
Cash realizable value	**€188,000**	**€188,000**

Recovery of an Uncollectible Account

Occasionally, a company collects from a customer after it has written off the account as uncollectible. The company makes two entries to record the recovery of a bad debt.

1. It reverses the entry made in writing off the account. This reinstates the customer's account.
2. It journalizes the collection in the usual manner.

To illustrate, assume that on July 1, R. A. Ware pays the €500 amount that Hampson had written off on March 1. Hampson makes the following entries.

(1)

July 1	Accounts Receivable	500	
	Allowance for Doubtful Accounts		500
	(To reverse write-off of R. A. Ware account)		

(2)

July 1	Cash	500	
	Accounts Receivable		500
	(To record collection from R. A. Ware)		

Note that the recovery of a bad debt, like the write-off of a bad debt, affects **only statement of financial position accounts**. The net effect of the two entries above is a debit to Cash and a credit to Allowance for Doubtful Accounts for €500. Accounts Receivable and Allowance for Doubtful Accounts both increase in entry (1) for two reasons. First, the company made an error in judgment when it wrote off the account receivable. Second, after R. A. Ware did pay, Accounts Receivable in

the general ledger and Ware's account in the subsidiary ledger should show the collection for possible future credit purposes.

Estimating the Allowance

For Hampson Furniture in Illustration 8.3, the amount of the expected uncollectibles was given. However, in "real life," companies must estimate the amount of expected uncollectible accounts if they use the allowance method. Expected uncollectible accounts are estimated based on information about past events (loss experience), adjusted for current conditions and reasonable forecasts of factors that would affect uncollectible accounts. While much judgment is involved, the goal is to develop the best estimate of expected uncollectible receivables. **Illustration 8.6** shows an excerpt from the notes to **Unilever**'s (GBR) financial statements discussing its use of the allowance method.

ILLUSTRATION 8.6 Unilever's allowance method disclosure

Frequently, companies estimate the allowance as a percentage of the outstanding receivables. Under the **percentage-of-receivables basis**, management establishes a percentage relationship between the amount of receivables and expected losses from uncollectible accounts (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Where appropriate, the percentage-of-receivables basis may use only a single percentage rate.**

For example, suppose Steffen Ltd. has an ending balance in Accounts Receivable of £200,000 and an unadjusted credit balance in Allowance for Doubtful Accounts of £1,500. It estimates that 5% of its accounts receivable will eventually be uncollectible. It should report a balance in Allowance for Doubtful Accounts of £10,000 (.05 × £200,000). To increase the balance in Allowance for Doubtful Accounts from £1,500 to £10,000, the company debits (increases) Bad Debt Expense and credits (increases) Allowance for Doubtful Accounts by £8,500 (£10,000 – £1,500).

Allowance for Doubtful Accounts

	Dec. 31 Unadj. Bal. 1,500
	Dec. 31 Adj. **8,500**
	Dec. 31 Bal. 10,000

To more accurately estimate the ending balance in the allowance account, a company often prepares a schedule, called **aging the accounts receivable**.

- This schedule classifies customer balances by the length of time they have been unpaid.
- After the company arranges the accounts by age, it determines the expected bad debt losses by applying percentages, based on past experience, to the totals of each category.
- The longer a receivable is past due, the less likely it is to be collected. As a result, the estimated percentage of uncollectible debts increases as the number of days past due increases.

Illustration 8.7 shows an aging schedule for Xi Electronics (amounts in thousands) (see **Helpful Hint**). Note the increasing uncollectible percentages from 2% to 40%.

ILLUSTRATION 8.7 Aging schedule

HELPFUL HINT

The older categories have higher percentages because the longer an account is past due, the less likely it is to be collected.

Total estimated uncollectible accounts for Xi Electronics (¥2,228) represent the existing customer claims expected to become uncollectible in the future.

- This amount represents the **required balance** in Allowance for Doubtful Accounts at the statement of financial position date.
- Accordingly, **the amount of bad debt expense that should be recorded in the adjusting entry is the difference between the required balance and the existing balance in the allowance account**.
- The existing, unadjusted balance in Allowance for Doubtful Accounts is the net result of the beginning balance (a normal credit balance) less the write-offs of specific accounts during the year (debits to the allowance account).

For example, if the unadjusted trial balance shows Allowance for Doubtful Accounts with a credit balance of ¥528, then an adjusting entry for ¥1,700 (¥2,228 – ¥528) is necessary:

Dec. 31	Bad Debt Expense	1,700	
	Allowance for Doubtful Accounts		1,700
	(To adjust allowance account to total estimated uncollectibles)		

After Xi posts the adjusting entry, its accounts appear as shown in Illustration 8.8.

ILLUSTRATION 8.8 Bad debt accounts after posting

Bad Debt Expense			Allowance for Doubtful Accounts	
Dec. 31 Adj.	1,700		Dec. 31 Unadj. Bal.	528
			Dec. 31 Adj.	1,700
			Dec. 31 Bal.	2,228

An important aspect of accounts receivable management is simply maintaining a close watch on the accounts. Studies have shown that accounts more than 60 days past due lose approximately 50% of their value if no payment activity occurs within the next 30 days. For each additional 30 days that pass, the collectible value halves once again.

Occasionally, the allowance account will have a **debit balance** prior to adjustment.

- This occurs because the debits to the allowance account from write-offs during the year **exceeded** the beginning balance in the account which was based on previous estimates for bad debts.
- In such a case, the company **addsthe debit balance to the required balance** when it makes the adjusting entry.

Thus, if there was a ¥500 **debit** balance in the allowance account before adjustment, the adjusting entry would be for ¥2,728 (¥2,228 + ¥500) to arrive at a credit balance of ¥2,228 as shown below.

Dec. 31	Bad Debt Expense	2,728	

	Allowance for Doubtful Accounts		2,728
	(To adjust allowance account to total estimated uncollectibles)		

After Xi posts the adjusting entry, its accounts appear as shown in Illustration 8.9.

ILLUSTRATION 8.9 Bad debt accounts after posting

Bad Debt Expense			
Dec. 31 Adj.	2,728		

Allowance for Doubtful Accounts			
Dec. 31 Unadj. Bal.	500	Dec. 31 Adj.	2,728
		Dec. 31 Bal.	2,228

The percentage-of-receivables basis provides an estimate of the **cash realizable value** of the receivables. The IASB now employs an expected credit loss model, which requires that companies must measure expected uncollectible accounts and record bad debt expense on all receivables, even those with a low risk of loss. Companies use sophisticated models employing data analytics to arrive at accurate estimates on a timely basis.

The note regarding accounts receivable shown in Illustration 8.10 comes from the annual report of the shoe company **Skechers USA** (USA).

ILLUSTRATION 8.10 Skechers USA's note disclosure of accounts receivable

Ethics Insight

Let's Keep These Earnings Up

In a recent period, many Chinese financial institutions including **ICBC** and **China Construction Bank** lowered their estimates of allowances for doubtful accounts set aside for bad loans. Profitability at the banks has declined as a result of the domestic and international economic outlook.

Rather than issuing financial reports that reflect this, financial institutions lowered the amounts of allowances accrued for bad debt expense. According to the largest state-owned banks, they would like to be more conservative in their treatment of non-performing loans, but the Chinese government insists that they protect profits and the steady stream of dividends they pay. Chinese regulators have encouraged the sector to take higher charges for bad debt expense in good quarters and lower charges in tough times, thus smoothing the ride downhill and avoiding major jolts.

Source: Adapted from Cathy Holcombe, "Chinese Banks Are Suddenly Being Frank about the Non-Performing Loans Mystery," *South China Morning Post* (November 7, 2016).

Are the banks' financial statements misleading to outside investors as a result of the decreased amount accrued for loan losses?

Answer

DO IT! 2a

Bad Debt Expense

Brule Group has been in business for 5 years. The unadjusted trial balance at the end of the current year shows Accounts Receivable $30,000, Sales Revenue $180,000, and Allowance for Doubtful Accounts with a debit balance of $2,000. Brule estimates bad debts to be 10% of accounts receivable. Prepare the entry necessary to adjust Allowance for Doubtful Accounts.

ACTION PLAN

- **Estimate the amount the company does not expect to collect.**
- **Consider the existing balance in the allowance account when using the percentage-of-receivables basis.**
- **Report receivables at their cash (net) realizable value—that is, the amount the company expects to collect in cash.**

Solution

Disposing of Accounts Receivable

In the normal course of events, companies collect accounts receivable in cash and remove the receivables from the books. However, as credit sales and receivables have grown in significance, the "normal course of events" has changed. Companies now frequently sell their receivables to another company for cash, thereby shortening the cash-to-cash operating cycle.

Companies sell receivables for two major reasons:

1. **Receivables may be the only reasonable source of cash**. When money is tight, companies may not be able to borrow money in the usual credit markets. Or if money is available, the cost of borrowing may be prohibitive.
2. **Billing and collection are often time-consuming and costly**. It is often easier for a retailer to sell the receivables to another party with expertise in billing and collection matters. Credit card companies such as **MasterCard** (USA) and **Visa** (USA) specialize in billing and collecting accounts receivable. MasterCard and Visa credit cards are issued by banks around the world, including **ICBC** (CHN), **BNP Paribas** (FRA), and **Barclays** (GBR).

Sale of Receivables to a Factor

A common sale of receivables is a sale to a factor. A **factor** is a finance company or bank that buys receivables from businesses and then collects the payments directly from the customers.

- Factoring is a multibillion dollar business, although factoring arrangements vary widely.
- Typically, the factor charges a commission to the company that is selling the receivables. This fee often ranges from 1–3% of the amount of receivables purchased.

To illustrate, assume that Keelung Jewelry factors NT$600,000 of receivables to Federal Factors (amounts in thousands). Federal Factors assesses a service charge of 2% of the amount of receivables sold. The journal entry to record the sale by Keelung Jewelry on April 2, 2025, is as follows.

Apr. 2	Cash	588,000	
	Service Charge Expense (2% × NT$600,000)		12,000

	Accounts Receivable		600,000
	(To record the sale of accounts receivable)		

If Keelung often sells its receivables, it records the service charge expense as an operating expense. If the company infrequently sells receivables, it may report this amount in the "Other income and expense" section of the income statement.

National Credit Card Sales

Credit card use is becoming widespread around the world. **ICBC** is among the largest credit card issuers in the world. **Visa** and **MasterCard** are the credit cards that most individuals use. Three parties are involved when national credit cards are used in retail sales:

1. The credit card issuer, which is independent of the retailer.
2. The retailer.
3. The customer.

A retailer's acceptance of a credit card is another form of selling (factoring) the receivable.

Illustration 8.11 shows the major advantages of credit cards to the retailer. In exchange for these advantages, the retailer pays the credit card issuer a fee of 2–4% of the invoice price for its services (see Ethics Note).

ILLUSTRATION 8.11 Advantages of credit cards to the retailer

> **ETHICS NOTE**
>
> **In exchange for lower interest rates, some companies have eliminated the 25-day grace period before finance charges kick in. Be sure you read the fine print in any credit agreement you sign.**

Accounting for Credit Card Sales

The retailer generally considers sales from the use of credit card sales as **cash sales**. The retailer must pay to the bank that issues the card a fee for processing the transactions. The retailer records the credit card slips in a similar manner as checks deposited from a cash sale.

To illustrate, Ling Lee purchases NT$6,000 of paper products for her restaurant from Wu Supplies using her Visa First Bank Card. First Bank charges a service fee of 3%. The entry to record this transaction by Wu Supplies on March 22, 2025, is as follows.

Mar. 22	Cash	5,820	
	Service Charge Expense	180	
	Sales Revenue		6,000
	(To record Visa credit card sales)		

Accounting Across the Organization Sogo Co., Ltd.

How Does a Credit Card Work?

Most of you know how to use a credit card, but do you know what happens in the transaction and how the transaction is processed? Suppose that you use a **Visa** card to purchase some new ties at **Sogo Co., Ltd.** (TWN). You swipe your credit card (or insert if it is a chip card) which allows the information on the magnetic strip on the back of the card to be read. The salesperson then enters the amount of the purchase. The machine contacts the Visa computer, which routes the call back to the bank that issued your Visa card. The issuing bank verifies that the account exists, that the card is not stolen, and that you have not exceeded your credit limit. At this point, the receipt is printed.

Visa acts as the clearing agent for the transaction. It transfers funds from the issuing bank to Sogo's bank account. Generally, this transfer of funds, from sale to the receipt of funds in the merchant's account, takes two to three days.

In the meantime, Visa puts a pending charge on your account for the amount of the purchase; that amount counts immediately against your available credit limit. At the end of the billing period, Visa sends you an invoice (your credit card bill) which shows the various charges you made, and the amounts that Visa expended on your behalf, for the month. You then must "pay the piper" for your stylish new ties.

Assume that Sogo prepares a bank reconciliation at the end of each month. If some credit card sales have not been processed by the bank, how should Sogo treat these transactions on its bank reconciliation?

Answer

DO IT! 2b

Factoring

Kell Wholesalers needs to raise €120,000 in cash to safely cover next Friday's employee payroll. Kell has reached its debt ceiling. Kell's present balance of outstanding receivables totals €750,000. Kell decides to factor €125,000 of its receivables on September 7, 2025, to alleviate this cash crunch. Record the entry that Kell would make when it raises the needed cash. (Assume a 1% service charge.)

ACTION PLAN

- **Consider sale of receivables to a factor.**
- **Weigh cost of factoring against benefit of having cash in hand.**

Solution

8.3 Notes Receivable

LEARNING OBJECTIVE 3

Explain how companies recognize, value, and dispose of notes receivable.

Companies may also grant credit in exchange for a formal credit instrument known as a promissory note. A **promissory note** is a written promise to pay a specified amount of money on demand or at

a definite time. Promissory notes may be used in the following cases.

1. When individuals and companies lend or borrow money.
2. When the amount of the transaction and the credit period exceed normal limits.
3. In settlement of accounts receivable.

In a promissory note, the party making the promise to pay is called the **maker**. The party to whom payment is to be made is called the **payee**. The note may specifically identify the payee by name or may designate the payee simply as the bearer of the note.

In the note shown in **Illustration 8.12**, Calhoun plc is the maker and Wilma Ltd. is the payee. To Wilma Ltd., the promissory note is a note receivable. To Calhoun plc, it is a note payable (see **Helpful Hint**).

ILLUSTRATION 8.12 **Promissory note**

> **HELPFUL HINT**
>
> **For this note, the maker, Calhoun plc, debits Cash and credits Notes Payable. The payee, Wilma Ltd. debits Notes Receivable and credits Cash.**

Notes receivable give the holder a stronger legal claim to assets than do accounts receivable. Like accounts receivable, notes receivable can be readily sold to another party. Promissory notes are negotiable instruments (as are checks), which means that they can be transferred to another party by endorsement.

- Companies frequently accept notes receivable from customers who need to extend the payment of an outstanding account receivable. They often require such notes from high-risk customers.
- In some industries (such as the pleasure and sport boat industry), all credit sales are supported by notes.
- The majority of notes, however, originate from lending transactions.

The basic issues in accounting for notes receivable are the same as those for accounts receivable. On the following pages, we look at these issues. Before we do, however, we need to consider two issues that do not apply to accounts receivable: determining the maturity date and computing interest.

Determining the Maturity Date

Illustration 8.13 shows three ways of stating the maturity date of a promissory note.

ILLUSTRATION 8.13 **Maturity date of different notes**

When the life of a note is expressed in terms of months, you find the date when it matures by counting the months from the date of issue. For example, the maturity date of a three-month note dated May 1 is August 1. A note drawn on the last day of a month matures on the last day of a subsequent month. That is, a July 31 note due in two months matures on September 30.

When the due date is stated in terms of days, you need to count the exact number of days to determine the maturity date. In counting, **omit the date the note is issued but include the due date**. For example, the maturity date of a 60-day note dated July 17 is September 15, computed as shown in **Illustration 8.14**.

ILLUSTRATION 8.14 Computation of maturity date

Term of note		60 days
July (31–17)	14	
August	31	45
Maturity date: September		**15**

Computing Interest

Illustration 8.15 gives the basic formula for computing interest on an interest-bearing note.

ILLUSTRATION 8.15 Formula for computing interest

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest

The interest rate specified in a note is an **annual** rate of interest (see Helpful Hint). The time factor in the formula in Illustration 8.15 expresses the fraction of a year that the note is outstanding.

> **HELPFUL HINT**
>
> **The interest rate specified is the *annual* rate.**

- When the maturity date is stated in days, the time factor is often the number of days divided by 360.
- Remember that when counting days, omit the date that the note is issued but include the due date.
- When the due date is stated in months, the time factor is the number of months divided by 12.

Illustration 8.16 shows computation of interest for various time periods.

ILLUSTRATION 8.16 Computation of interest

Terms of Note		Interest Computation						
		Face	×	Rate	×	Time	=	Interest
₺ 730,	12%, 120 days	₺ 730	×	12%	×	**120/360**	=	₺ 29.20
₺ 1,000,	9%, 6 months	₺ 1,000	×	9%	×	**6/12**	=	₺ 45.00
₺ 2,000,	6%, 1 year	₺ 2,000	×	6%	×	**1/1**	=	₺ 120.00

There are different ways to calculate interest. For example, the computation in Illustration 8.16 assumes 360 days for the length of the year. Most financial institutions use 365 days to compute interest. *For homework problems, assume 360 days to simplify computations.*

Recognizing Notes Receivable

To illustrate the basic entry for notes receivable, we will use Calhoun plc's £1,000, two-month, 12% promissory note dated May 1. Assuming that Calhoun plc wrote the note to settle an open account, Wilma Ltd. makes the following entry for the receipt of the note.

May 1	Notes Receivable	1,000	
	Accounts Receivable		1,000
	(To record acceptance of Calhoun plc note)		

The company records the note receivable at its **face value**, the value shown on the face of the note. No interest revenue is reported when the note is accepted because the revenue recognition principle does not recognize revenue until the performance obligation is satisfied. Interest is earned (accrued) as time passes.

If a company issues cash in exchange for a note, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the loan.

Valuing Notes Receivable

Valuing short-term notes receivable is the same as valuing accounts receivable. Like accounts receivable, companies report short-term notes receivable at their **cash (net) realizable value**. The notes receivable allowance account is Allowance for Doubtful Accounts. The estimations involved in determining cash realizable value and in recording bad debt expense and the related allowance are done similarly to accounts receivable.

Disposing of Notes Receivable

Notes may be held to their maturity date, at which time the face value plus accrued interest is due. In some situations, the maker of the note defaults, and the payee must make an appropriate adjustment. In other situations, similar to accounts receivable, the holder of the note speeds up the conversion to cash by selling the receivables (as described earlier in this chapter).

Honor of Notes Receivable

A note is **honored** when its maker pays in full at its maturity date. For each interest-bearing note, the **amount due at maturity** is the face value of the note plus interest for the length of time specified on the note.

To illustrate, assume that Wolder Co. lends Higley Co. €10,000 on June 1, accepting a five-month, 9% interest note. In this situation, interest is €375 (€10,000 × 9% × $\frac{5}{12}$). The amount due, **the maturity value**, is €10,375 (€10,000 + €375). To obtain payment, Wolder (the payee) must present the note either to Higley (the maker) or to the maker's agent, such as a bank. If Wolder presents the note to Higley on November 1, the maturity date, Wolder's entry to record the collection is as follows.

Nov. 1	Cash	10,375	
	Notes Receivable		10,000
	Interest Revenue (€10,000 × 9% × $\frac{5}{12}$)		375
	(To record collection of Higley note and interest)		

Accrual of Interest Receivable

Suppose instead that Wolder Co. prepares financial statements as of September 30. The timeline in Illustration 8.17 presents this situation.

ILLUSTRATION 8.17 Timeline of interest earned

To reflect interest earned but not yet received, Wolder must accrue interest on September 30. In this case, the adjusting entry by Wolder is for four months of interest, or €300, as shown below.

Sept. 30	Interest Receivable (€10,000 × 9% × $\frac{4}{12}$)412	300	

	Interest Revenue		300
	(To accrue 4 months' interest on Higley note)		

At the note's maturity on November 1, Wolder receives €10,375. This amount represents repayment of the €10,000 note as well as five months of interest, or €375, as shown below. The €375 is comprised of the €300 Interest Receivable accrued on September 30 plus €75 earned during October. Wolder's entry to record the honoring of the Higley note on November 1 is as follows.

Nov. 1	Cash [€10,000 + (€10,000 × 9% × $\frac{5}{12}$)]	10,375	
	Notes Receivable		10,000
	Interest Receivable		300
	Interest Revenue (€10,000 × 9% × $\frac{1}{12}$)]		75
	(To record collection of Higley note and interest)		

In this case, Wolder credits Interest Receivable because the receivable was established in the adjusting entry on September 30.

Dishonor of Notes Receivable

A **dishonored (defaulted) note** is a note that is not paid in full at maturity.

- A dishonored note receivable is no longer negotiable, but the payee still has a claim against the maker of the note for both the note and the interest.
- Therefore, the note holder usually transfers the Notes Receivable account to an Accounts Receivable account.

To illustrate, assume that Higley Co. on November 1 indicates that it cannot pay at the present time. The entry to record the dishonor of the note depends on whether Wolder Co. expects eventual collection. If it does expect eventual collection, Wolder Co. debits the amount due (face value and interest) on the note to Accounts Receivable. It would make the following entry at the time the note is dishonored (assuming no previous accrual of interest).

Nov. 1	Accounts Receivable	10,375	
	Notes Receivable		10,000
	Interest Revenue		375
	(To record the dishonor of Higley note)		

If instead on November 1 there is no hope of collection, the note holder would write off the face value of the note by debiting Allowance for Doubtful Accounts. No interest revenue would be recorded because collection will not occur.

Ethics Insight

Let the "Good Times" Roll

Following the 2008 global financial crisis, governments in India and elsewhere eased monetary and regulatory policies in an effort to encourage economic growth. India's state-controlled banking system became clogged with bad debt. While some in banking claim that irrational exuberance and inadequate evaluation of borrowers were to blame, others point to years of well-connected politicians and industrialists using their influence to get cheap loans.

For example, larger-than-life Indian tycoon Vijay Mallya used his political connections to borrow almost Rs 7,000 to finance **Kingfisher Airlines** (IND) and other projects, including his brewery and Formula 1 racing team. The self-appointed "King of the Good Times" fled the country after being accused of laundering money, bribing bank officials, and defaulting on loans.

Source: Adapted from Megha Bahree, "Vijay Mallya, Indian 'King of the Good Times,' Dethroned by Debt," *The New York Times* (April 28, 2016).

What factors should be considered in evaluating loan applications?

Answer

DO IT! 3

Recognizing Notes Receivable

Gambit Stores accepts from Leonard Co. a $3,400, 90-day, 6% note dated May 10 in settlement of Leonard's overdue account. (a) What is the maturity date of the note? (b) What is the interest payable at the maturity date? (c) What entry does Gambit make at the maturity date, assuming Leonard pays the note and interest in full at that time?

ACTION PLAN

- **Count the exact number of days to determine the maturity date. Omit the date the note is issued, but include the due date.**
- **Compute the accrued interest.**
- **Prepare the entry for payment of the note and the interest.**

Solution

Related exercise material: **BE8.8**, **BE8.9**, **BE8.10**, **DO IT! 8.3**, **E8.12**, **E8.13**, **and** **E8.14**.

8.4 Presentation and Analysis

LEARNING OBJECTIVE 4

Describe the statement presentation and analysis of receivables.

If a company has significant receivables, analysts carefully review the company's financial statement disclosures to evaluate how well the company is managing its receivables.

Presentation

Companies should identify in the statement of financial position or in the notes to the financial statements each of the major types of receivables.

- Short-term receivables appear in the current assets section of the statement of financial position. Short-term investments appear after short-term receivables because these investments are more liquid (nearer to cash).
- Companies report both the gross amount of receivables and the allowance for doubtful accounts.

In a multiple-step income statement, companies report bad debt expense and service charge expense in the operating expenses section. Interest revenue appears under "Other income and expense" in the non-operating activities section of the income statement.

Analysis

Investors and company managers compute financial ratios to evaluate the liquidity of a company's accounts receivable. They use the **accounts receivable turnover** to assess the liquidity of the receivables.

- This ratio measures the number of times, on average, the company collects accounts receivable during the period.
- It is computed by dividing net credit sales (net sales less cash sales) by the average net accounts receivable during the year.
- Unless seasonal factors are significant, average net accounts receivable outstanding can be computed from the beginning and ending balances of net accounts receivable.

For example, in a recent year **Lenovo Group** (CHN) (which reported in U.S. dollars) had net sales of $38,707 million for the year. It had a beginning accounts receivable (net) balance of $2,885 million and an ending accounts receivable (net) balance of $3,171 million. Assuming that Lenovo's sales were all on credit, its accounts receivable turnover is computed as shown in **Illustration 8.18**.

ILLUSTRATION 8.18 Accounts receivable turnover and computation

Net Credit Sales	÷	Average Net Accounts Receivable	=	Accounts Receivable Turnover
$38,707	÷	$\frac{\$2,885 + \$3,171}{2}$	=	12.8 times

The result indicates an accounts receivable turnover of 12.8 times per year. The higher the turnover, the more liquid the company's receivables.

A variant of the accounts receivable turnover that makes the liquidity even more evident is its conversion into an **average collection period** in terms of days. This is done by dividing the turnover into 365 days. For example, Lenovo's turnover of 12.8 times is divided into 365 days, as shown in **Illustration 8.19**, to obtain approximately 28.5 days. This means that it takes Lenovo on average 28.5 days to collect its accounts receivable.

ILLUSTRATION 8.19 Average collection period for receivables formula and computation

Days in Year	÷	Accounts Receivable Turnover	=	Average Collection Period in Days
365 days	÷	12.8 times	=	28.5 days

Companies frequently use the average collection period to assess the effectiveness of a company's credit and collection policies. The general rule is that the collection period should not greatly exceed the credit term period (that is, the time allowed for payment).

Data Analytics and Receivables Management

Opportunities abound to improve receivables management through data analytics. Software packages promise increases in working capital, improved revenues, and enhanced customer relations. Visualization software, which presents data in sophisticated graph format, enables managers to more quickly identify issues and obtain a deeper understanding of the factors that influence successful receivables management.

- Use of such software helps identify which currencies, sales representatives, customers, product lines, or geographic regions need closer attention.
- This sometimes enables management to do a more granular investigation of the cash-to-cash cycle time to evaluate which product lines are meeting company goals.

Data analytics of receivables is particularly valuable for predictive analysis which allows improved evaluation of customers' risk profiles. In many instances, the company can identify risky customers and take corrective action before problems arise. Software provided by companies such as **Workday** (USA) use artificial intelligence to forecast which customers are likely to pay late.

Finally, with Tableau or other visualization software, companies create dashboards that provide dynamic tracking and analysis of their receivables position. The Tableau dashboard shown in Illustration 8.20 provides an accounts receivable aging schedule, total amount of receivables, number of outstanding invoices, percent of overdue invoices, and average collection time. With this dashboard, the manager can zoom in on detailed information about specific customers, as well as change the due date or time period covered.

ILLUSTRATION 8.20 Tableau accounts receivable dashboard

DO IT! 4

Analysis of Receivables

In 2025, Nadal Racquets has net credit sales of €923,795 for the year. It had a beginning accounts receivable (net) balance of €38,275 and an ending accounts receivable (net) balance of €35,988. Compute Nadal's (a) accounts receivable turnover and (b) average collection period in days.

ACTION PLAN

- **Review the formula to compute the accounts receivable turnover.**
- **Make sure that both the beginning and ending accounts receivable balances are considered in the computation.**
- **Review the formula to compute the average collection period in days.**

Solution

Related exercise material: BE8.11, BE8.12, DO IT! 8.4, and E8.17.

Review and Practice

Learning Objectives Review

1 Explain how companies recognize accounts receivable.

Receivables are frequently classified as (1) accounts, (2) notes, and (3) other. Accounts receivable are amounts customers owe on account. Notes receivable are claims for which lenders issue formal

instruments of credit as proof of the debt. Other receivables include non-trade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

Companies record accounts receivable when they perform a service on account or at the point of sale of merchandise on account. Accounts receivable are reduced by sales returns and allowances. Cash discounts reduce the amount received on accounts receivable. When interest is charged on a past due receivable, the company adds this interest to the accounts receivable balance and recognizes it as interest revenue.

2 Describe how companies value accounts receivable and record their disposition.

There are two methods of accounting for uncollectible accounts: the allowance method and the direct write-off method. Companies use the percentage-of-receivables basis to estimate uncollectible accounts using the allowance method. The percentage-of-receivables basis emphasizes the cash realizable value of the accounts receivable. An aging schedule is often used with this basis.

When a company collects an account receivable, it credits Accounts Receivable. When a company sells (factors) an account receivable, a service charge expense reduces the amount received.

3 Explain how companies recognize, value, and dispose of notes receivable.

For a note stated in months, the maturity date is found by counting the months from the date of issue. For a note stated in days, the number of days is counted, omitting the issue date and counting the due date. The formula for computing interest is Face value × Interest rate × Time.

Companies record notes receivable at face value. In some cases, it is necessary to accrue interest prior to maturity. In this case, companies debit Interest Receivable and credit Interest Revenue.

Notes can be held to maturity. At that time, the face value plus accrued interest is due, and the note is removed from the accounts. In many cases, the holder of the note speeds up the conversion by selling the receivable to another party (a factor). In some situations, the maker of the note dishonors the note (defaults), in which case the company transfers the note and accrued interest to an account receivable or writes off the note.

4 Describe the statement presentation and analysis of receivables.

As with accounts receivable, companies report notes receivable at their cash (net) realizable value. The notes receivable allowance account is Allowance for Doubtful Accounts. The computation and estimations involved in valuing notes receivable at cash realizable value, and in recording the proper amount of bad debt expense and the related allowance, are similar to those for accounts receivable.

Companies should identify in the statement of financial position or in the notes to the financial statements each major type of receivable. Short-term receivables are considered current assets. Companies report the gross amount of receivables and the allowance for doubtful accounts. They report bad debt and service charge expenses in the multiple-step income statement as operating (selling) expenses. Interest revenue appears under other income and expense in the non-operating activities section of the statement. Managers and investors evaluate accounts receivable for liquidity by computing a turnover ratio and an average collection period.

Glossary Review

Accounts receivable
Amounts owed by customers on account.

Accounts receivable turnover
A measure of the liquidity of accounts receivable; computed by dividing net credit sales by average net accounts receivable.

Aging the accounts receivable
The analysis of customer balances by the length of time they have been unpaid.

Allowance method
A method of accounting for bad debts that involves estimating uncollectible accounts at the end of each period.

Average collection period
The average amount of time that a receivable is outstanding; calculated by dividing 365 days by the accounts receivable turnover.

Bad Debt Expense
An expense account to record uncollectible receivables.

Cash (net) realizable value
The net amount a company expects to receive in cash.

Direct write-off method
A method of accounting for bad debts that involves expensing accounts at the time they are determined to be uncollectible.

Dishonored (defaulted) note
A note that is not paid in full at maturity.

Factor
A finance company or bank that buys receivables from businesses and then collects the payments directly from the customers.

Maker
The party in a promissory note who is making the promise to pay.

Notes receivable
Written promise (as evidenced by a formal instrument) for amounts to be received.

Other receivables
Various forms of non-trade receivables, such as interest receivable and income taxes refundable.

Payee
The party to whom payment of a promissory note is to be made.

Percentage-of-receivables basis
Management estimates what percentage of receivables will result in losses from uncollectible accounts.

Promissory note
A written promise to pay a specified amount of money on demand or at a definite time.

Receivables
Amounts due from individuals and other companies.

Trade receivables
Notes and accounts receivable that result from sales transactions.

Practice Multiple-Choice Questions

1. **(LO 1)** Receivables are frequently classified as:

   a. accounts receivable, company receivables, and other receivables.

   b. accounts receivable, notes receivable, and employee receivables.

   c. accounts receivable and general receivables.

   d. accounts receivable, notes receivable, and other receivables.

Solution

2. (LO 1) Buehler Company on June 15 sells merchandise on account to Chaz Co. for $1,000, terms 2/10, n/30. On June 20, Chaz Co. returns merchandise worth $300 to Buehler Company. On June 24, payment is received from Chaz Co. for the balance due. What is the amount of cash received?

a. $700.

b. $680.

c. $686.

d. None of the answer choices is correct.

Solution

3. (LO 2) Hughes plc has a credit balance of £5,000 in its Allowance for Doubtful Accounts before any adjustments are made at the end of the year. Based on review and aging of its accounts receivable at the end of the year, Hughes estimates that £60,000 of its receivables are uncollectible. The amount of bad debt expense which should be reported for the year is:

a. £5,000.

b. £55,000.

c. £60,000.

d. £65,000.

Solution

4. (LO 2) Use the same information as in Question 3, except that Hughes has a debit balance of £5,000 in its Allowance for Doubtful Accounts before any adjustments are made at the end of the year. In this situation, the amount of bad debt expense that should be reported for the year is:

a. £5,000.

b. £55,000.

c. £60,000.

d. £65,000.

Solution

5. (LO 2) Accounts receivable at the end of the month are €800,000. Bad debts are expected to be 1.5% of accounts receivable. If Allowance for Doubtful Accounts has a credit balance of €1,000 before adjustment, what is the balance after adjustment?

a. €7,000.

b. €11,000.

c. €12,000.

d. €13,000.

Solution

6. (LO 2) At December 31, 2025, Carlson Enterprises had accounts receivable of ₺750,000. On January 1, 2025, Allowance for Doubtful Accounts had a credit balance of ₺18,000. During 2025, ₺30,000 of uncollectible accounts receivable were written off. Past experience indicates that 3% of accounts receivable become uncollectible. What should be the bad debt expense for 2025?

a. ₺10,500.

b. ₺22,500.

c. ₺30,000.

d. Ł34,500.

Solution

7. (LO 2) An analysis and aging of the accounts receivable of Prince Ltd. at December 31 reveals the following data.

Accounts receivable	£800,000
Allowance for doubtful accounts per books before adjustment	50,000
Amounts expected to become uncollectible	65,000

The cash realizable value of the accounts receivable at December 31, after adjustment, is:

a. £685,000.

b. £750,000.

c. £800,000.

d. £735,000.

Solution

8. (LO 2) Which of the following statements about Visa credit card sales is **incorrect**?

a. The credit card issuer makes the credit investigation of the customer.

b. The retailer is not involved in the collection process.

c. Two parties are involved.

d. The retailer receives cash more quickly than it would from individual customers on account.

Solution

9. (LO 2) Blinka Retailers accepted HK$500,000 of Citibank Visa credit card charges for merchandise sold on July 1. Citibank charges 4% for its credit card use. The entry to record this transaction by Blinka Retailers will include a credit to Sales Revenue of HK$500,000 and a debit(s) to:

a. Cash	HK$480,000
and Service Charge Expense	HK$20,000
b. Accounts Receivable	HK$480,000
and Service Charge Expense	HK$20,000
c. Cash	HK$500,000
d. Accounts Receivable	HK$500,000

Solution

10. (LO 3) One of the following statements about promissory notes is incorrect. The **incorrect** statement is:

a. The party making the promise to pay is called the maker.

b. The party to whom payment is to be made is called the payee.

c. A promissory note is not a negotiable instrument.

d. A promissory note is often required from high-risk customers.

Solution

11. (LO 3) Foti Co. accepts a $1,000, 3-month, 6% promissory note in settlement of an account with Bartelt Co. The entry to record this transaction is as follows.

a. Notes Receivable	1,015	
Accounts Receivable		1,015
b. Notes Receivable	1,000	
Accounts Receivable		1,000
c. Notes Receivable	1,000	
Sales Revenue		1,000
d. Notes Receivable	1,030	
Accounts Receivable		1,030

Solution

12. (LO 3) Ginter Ltd. holds Kolar Co.'s NT$10,000, 120-day, 9% note (amounts in thousands). The entry made by Ginter when the note is collected, assuming no interest has been previously accrued, is:

a. Cash	1,300	
Notes Receivable		1,300
b. Cash	10,000	
Notes Receivable		10,000
c. Accounts Receivable	10,300	
Notes Receivable		10,000
Interest Revenue		300
d. Cash	10,300	
Notes Receivable		10,000
Interest Revenue		300

Solution

13. (LO 4) Accounts and notes receivable are reported in the current assets section of the statement of financial position at:

a. cash (net) realizable value.

b. net book value.

c. lower-of-cost-or-net realizable value.

d. invoice cost.

Solution

14. (LO 4) Shin Industries had net credit sales during the year of ¥800,000 and cost of goods sold of ¥500,000 (amounts in thousands). The balance in accounts receivable at the beginning of

the year was ¥100,000, and the end of the year it was ¥150,000. What were the accounts receivable turnover and the average collection period in days?

a. 4.0 and 91.3 days.

b. 5.3 and 68.9 days.

c. 6.4 and 57 days.

d. 8.0 and 45.6 days.

Solution

Practice Brief Exercises

Record basic accounts receivable transactions.

1. (LO 1) Record the following transactions on the books of Gwok Toys (amounts in thousands).

1. On August 1, Gwok sold merchandise on account to Miguel Imports for NT$15,500, terms 1/10, n/30.
2. On August 8, Miguel returned merchandise worth NT$3,100 to Gwok.
3. On August 11, Miguel paid for the merchandise.

Solution

Prepare entry using percentage-of-receivables method.

2. (LO 2) Sanchez Vineyards uses the percentage-of-receivables basis in 2025 to record bad debt expense. It estimates that 3% of accounts receivable will become uncollectible. Sales revenues are €900,000 for 2025, and sales returns and allowances are €50,000. At December 31, 2025, the balance in accounts receivable is €139,000, and the allowance for doubtful accounts has a credit balance of €3,000. Prepare the adjusting entry to record bad debt expense in 2025.

Solution

Prepare entry for notes receivable exchanged for account receivable.

3. (LO 3) On January 20, 2025, Carlos Co. sold merchandise on account to Carson Co. for $20,000, n/30. On February 19, Carson Co. gave Carlos Co. an 8% promissory note in settlement of this account. Prepare the journal entry to record the sale and the settlement of the account receivable.

Solution

Practice Exercises

Journalize entries to record allowance for doubtful accounts using two different bases.

1. (LO 2) The ledger of Nuro Metalworks at the end of the current year shows Accounts Receivable £180,000, Sales Revenue £1,800,000, and Sales Returns and Allowances £60,000.

Instructions

a. If Nuro uses the direct write-off method to account for uncollectible accounts, journalize the adjusting entry at December 31, assuming Nuro determines that £2,900 of the accounts receivable is uncollectible.

b. If Allowance for Doubtful Accounts has a credit balance of £4,300 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be 10% of accounts receivable.

c. If Allowance for Doubtful Accounts has a debit balance of £410 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be 6% of accounts receivable.

Solution

Journalize entries for notes receivable transactions.

2. (LO 3) Sargeant Supply has the following transactions related to notes receivable during the last 2 months of 2025.

Nov. 1	Loaned CHF20,000 cash to Mary Hawkins on a 1-year, 12% note.
Dec. 11	Sold goods to Eminem, Inc., receiving a CHF9,000, 90-day, 8% note.
16	Received a CHF8,000, 6-month, 9% note in exchange for Rick DeLong's outstanding accounts receivable.
31	Accrued interest revenue on all notes receivable.

Instructions

a. Journalize the transactions for Sargeant Supply.

b. Record the collection of the Hawkins note at its maturity in 2026.

Solution

Practice Problem

Prepare entries for various receivables transactions.

(LO 1, 2, 3) The following selected transactions relate to Dylan Confectioners (amounts in thousands).

Mar. 1	Sold ₩20,000 of merchandise to Hé Ltd., terms 2/10, n/30.
11	Received payment in full from Hé for balance due from the March 1 transaction.
12	Accepted Juno Company's ₩20,000, 6-month, 12% note for balance due on outstanding account receivable.
13	Made Dylan credit card sales for ₩13,200.
15	Made Visa credit card sales totaling ₩6,700. A 3% service fee is charged by Visa.
Apr. 11	Sold accounts receivable of ₩8,000 to Harcot Factor. Harcot assesses a service charge of 2% of the amount of receivables sold.
13	Received collections of ₩8,200 on Dylan credit card sales and added finance charges of 1.5% to the remaining balances.

May 10 Wrote off as uncollectible ₩16,000 of accounts receivable. Dylan uses the percentage-of-receivables basis to estimate bad debts.

June 30 Accounts receivable total ₩2,000,000. The bad debt percentage is 1% of accounts receivable. At June 30, the balance in the allowance account is a credit balance of ₩3,500 before adjustment.

July 16 One of the accounts receivable written off in May was from Juli Chan, who pays the amount due, ₩4,000, in full.

Instructions

Prepare the journal entries for the transactions. (Ignore entries for cost of goods sold.)

Solution

Questions

1. What is the difference between an account receivable and a note receivable?

2. What are some common types of receivables other than accounts receivable and notes receivable?

3. **Texaco Oil Company** (USA) issues its own credit cards. Assume that Texaco charges you $40 interest on an unpaid balance. Prepare the journal entry that Texaco makes to record this revenue.

4. What are the essential features of the allowance method of accounting for bad debts?

5. Roger Holloway cannot understand why cash realizable value does not decrease when an uncollectible account is written off under the allowance method. Clarify this point for Roger.

6. What types of receivables does **TSMC** report on its statement of financial position (see Appendix A)? Does it use the allowance method or the direct write-off method to account for uncollectibles?

7. Borke Ltd. has a credit balance of NT$300,000 in Allowance for Doubtful Accounts before adjustment. The total estimated uncollectibles under the percentage-of-receivables basis is NT$580,000. Prepare the adjusting entry to record bad debt expense.

8. How are bad debts accounted for under the direct write-off method? What are the disadvantages of this method?

9. Regina Golden, the vice president of sales for Tropical Pools and Spas, wants the company's credit department to be less restrictive in granting credit. "How can we sell anything when you guys won't approve anybody?" she asks. Discuss the pros and cons of easy credit. What are the accounting implications?

10. Freida ASA accepts both its own and other credit cards. What are the advantages of accepting both types of cards?

11. An article recently appeared in the *Wall Street Journal* indicating that companies are selling their receivables at a record rate. Why are companies selling their receivables?

12. Westside Textiles decides to sell HK$8,000,000 of its accounts receivable to First Factors. First Factors assesses a service charge of 3% of the amount of receivables sold. Prepare the journal entry that Westside Textiles makes to record this sale.

13. Your roommate is uncertain about the advantages of a promissory note. Compare the advantages of a note receivable with those of an account receivable.

14. How may the maturity date of a promissory note be stated?

15. Indicate the maturity date of each of the following promissory notes:

	Date of Note	Terms
a.	March 13	one year after date of note
b.	May 4	3 months after date
c.	June 20	30 days after date
d.	July 1	60 days after date

16. Compute the missing items for each of the following notes.

	Principal	Annual Interest Rate	Time	Total Interest
a.	?	9%	120 days	€ 450
b.	€30,000	10%	3 years	?
c.	€60,000	?	5 months	€1,500
d.	€45,000	8%	?	€1,200

17. Jana Company dishonors a note at maturity. What are the options available to the lender?

18. **Toyota Motor Company** (JPN) has accounts receivable and notes receivable. How should the receivables be reported on the statement of financial position?

19. The accounts receivable turnover is 8.14, and average net receivables during the period are 400,000. What is the amount of net credit sales for the period?

20. What percentage does **TSMC**'s 2020 allowance for doubtful accounts represent as a percentage of its gross receivables (see Appendix A)?

Brief Exercises

Identify different types of receivables.

BE8.1 (LO 1) Presented below are three receivables transactions. Indicate whether these receivables are reported as accounts receivable, notes receivable, or other receivables on a statement of financial position.

a. Sold merchandise on account for 64,000,000 to a customer.

b. Received a promissory note of 57,000,000 for services performed.

c. Advanced ₩10,000,000 to an employee.

Record basic accounts receivable transactions.

BE8.2 (LO 1) Record the following transactions on the books of RAS Co.

a. On July 1, RAS Co. sold merchandise on account to Waegelein Inc. for $17,200, terms 2/10, n/30.

b. On July 8, Waegelein Inc. returned merchandise worth $3,800 to RAS Co.

c. On July 11, Waegelein Inc. paid for the merchandise.

Prepare entry for allowance method and partial statement of financial position.

BE8.3 (LO 2, 4) During its first year of operations, Energy Solutions had credit sales of €3,000,000; €600,000 remained uncollected at year-end. The credit manager estimates that €31,000 of these receivables will become uncollectible.

a. Prepare the journal entry to record the estimated uncollectibles.

b. Prepare the current assets section of the statement of financial position for Energy Solutions. Assume that in addition to the receivables it has cash of €90,000, inventory of €130,000, and prepaid insurance of €7,500.

Prepare entry for write-off; determine cash realizable value.

BE8.4 (LO 2) At the end of 2025, Chin Appliances has accounts receivable of ¥700,000 and an allowance for doubtful accounts of ¥54,000 (amounts in thousands). On January 24, 2026, the company learns that its receivable from Megan Gray is not collectible, and management authorizes a write-off of ¥6,200.

a. Prepare the journal entry to record the write-off.

b. What is the cash realizable value of the accounts receivable (1) before the write-off and (2) after the write-off?

Prepare entries for collection of bad debt write-off.

BE8.5 (LO 2) Assume the same information as BE8.4. On March 4, 2026, Chin Appliances receives payment of ¥6,200 in full from Megan Gray. Prepare the journal entries to record this transaction.

Prepare entry using percentage-of-receivables method.

BE8.6 (LO 2) Kingston Publishers uses the percentage-of-receivables basis to record bad debt expense. It estimates that 1% of accounts receivable will become uncollectible. Accounts receivable are £420,000 at the end of the year, and the allowance for doubtful accounts has a credit balance of £1,500.

a. Prepare the adjusting journal entry to record bad debt expense for the year.

b. If the allowance for doubtful accounts had a debit balance of £800 instead of a credit balance of £1,500, determine the amount to be reported for bad debt expense.

Prepare entries to dispose of accounts receivable.

BE8.7 (LO 2) Presented below are two independent transactions.

a. Fiesta Restaurant accepted a Visa card in payment of a €175 lunch bill. The bank charges a 4% fee. What entry should Fiesta make?

b. St. Pierre AG sold its accounts receivable of €60,000. What entry should St. Pierre make, given a service charge of 3% on the amount of receivables sold?

Compute interest and determine maturity dates on notes.

BE8.8 (LO 3) Compute interest and find the maturity date for the following notes (NT$ in thousands).

	Date of Note	Principal	Interest Rate (%)	Terms
a.	June 10	NT$80,000	6%	60 days
b.	July 14	NT$64,000	7%	90 days
c.	April 27	NT$12,000	8%	75 days

Determine maturity dates and compute interest and rates on notes.

BE8.9 (LO 3) Presented below are data on three promissory notes. Determine the missing amounts.

	Date of Note	Terms	Maturity Date	Principal	Annual Interest Rate	Total Interest
a.	April 1	60 days	?	₺ 600,000	6%	?

	Date of Note	Terms	Maturity Date	Principal	Annual Interest Rate	Total Interest
b.	July 2	30 days	?	90,000	?	Ł600
c.	March 7	6 months	?	120,000	10%	?

Prepare entry for notes receivable exchanged for account receivable.

BE8.10 (LO 3) On January 10, 2025, Wilfer Ltd. sold merchandise on account to Robertsen Co. for HK$84,600, n/30. On February 9, Robertsen Co. gave Wilfer Ltd. a 10% promissory note in settlement of this account. Prepare the journal entry to record the sale and the settlement of the account receivable. (Omit cost of goods sold entries.)

Prepare entry for estimated uncollectibles and classifications, and compute ratios.

BE8.11 (LO 2, 4) During its first year of operations, Fertig Retail had credit sales of R$3,000,000, of which R$400,000 remained uncollected at year-end. The credit manager estimates that R$18,000 of these receivables will become uncollectible.

a. Prepare the journal entry to record the estimated uncollectibles. (Assume an unadjusted balance of zero in Allowance for Doubtful Accounts.)

b. Prepare the current assets section of the statement of financial position for Fertig Retail, assuming that in addition to the receivables it has cash of R$90,000, merchandise inventory of R$180,000, and supplies of R$13,000.

c. Calculate the accounts receivable turnover and average collection period. Assume that average net accounts receivable were R$300,000. Explain what these measures tell us.

Compute ratios to analyze receivables.

BE8.12 (LO 4) The financial statements of **Minnesota Mining and Manufacturing Company (3M)** (USA) report net sales of $20.0 billion. Accounts receivable (net) are $2.7 billion at the beginning of the year and $2.8 billion at the end of the year. Compute 3M's accounts receivable turnover. Compute 3M's average collection period for accounts receivable in days.

DO IT! Exercises

Prepare entries to recognize accounts receivable.

DO IT! 8.1 (LO 1) On March 1, Lincoln sold merchandise on account to Amelia Stores for €28,000, terms 1/10, net 45. On March 6, Amelia returns merchandise with a sales price of €1,000. On March 11, Lincoln receives payment from Amelia for the balance due. Prepare journal entries to record the March transactions on Lincoln's books. (You may ignore cost of goods sold entries and explanations.)

Prepare entry for uncollectible accounts.

DO IT! 8.2a (LO 2) Gonzalez Fashions has been in business several years. At the end of the current year, the ledger shows the following:

Accounts Receivable	R$ 310,000 Dr.
Sales Revenue	2,200,000 Cr.
Allowance for Doubtful Accounts	6,100 Cr.

Bad debts are estimated to be 5% of accounts receivable. Prepare the entry to adjust Allowance for Doubtful Accounts.

Prepare entry for factored accounts.

DO IT! 8.2b (LO 2) Neumann Distributors is a growing company whose ability to raise capital has not been growing as quickly as its expanding assets and sales. Neumann's local banker has indicated that the company cannot increase its borrowing for the foreseeable future. Neumann's suppliers are demanding payment for goods acquired within 30 days of the invoice date, but Neumann's customers are slow in paying for their purchases (60–90 days). As a result, Neumann has a cash flow problem.

Neumann needs €160,000 to cover next Friday's payroll. Its balance of outstanding accounts receivable totals €800,000. To alleviate this cash crunch, the company sells €170,000 of its receivables. Record the entry that Neumann would make. (Assume a 2% service charge.)

Compute maturity date and interest on note.

DO IT! 8.3 (LO 3) Gentry Wholesalers accepts from Benton Stores a £6,200, 4-month, 9% note dated May 31 in settlement of Benton's overdue account. (a) What is the maturity date of the note? (b) What is the interest payable at the maturity date?

Compute ratios for receivables.

DO IT! 8.4 (LO 4) In 2025, Wainwright Drugstores has net credit sales of NT$1,300,000 for the year (amounts in thousands). It had a beginning accounts receivable (net) balance of NT$101,000 and an ending accounts receivable (net) balance of NT$107,000. Compute Wainwright Drugstore's (a) accounts receivable turnover and (b) average collection period in days.

Exercises

Prepare entries for recognizing accounts receivable.

E8.1 (LO 1) On January 6, Malta Ltd. sells merchandise on account to Harley Inc. for £9,200, terms 1/10, n/30. On January 16, Harley pays the amount due.

Instructions

Prepare the entries on Malta's books to record the sale and related collection. (Omit cost of goods sold entries.)

Journalize entries related to accounts receivable.

E8.2 (LO 1) Presented below are selected transactions of Federer Apparel. Federer sells in large quantities to other companies and also sells its product in a small retail outlet.

March 1	Sold merchandise on account to Lynda Company for CHF5,000, terms 2/10, n/30.
3	Lynda Company returned merchandise worth CHF500 to Federer.
9	Federer collected the amount due from Lynda Company from the March 1 sale.
15	Federer sold merchandise for CHF400 in its retail outlet. The customer used his Federer credit card.
31	Federer added 1.5% monthly interest to the customer's credit card balance.

Instructions

Prepare journal entries for the transactions above. (Ignore cost of goods sold entries and explanations.)

Journalize entries for recognizing accounts receivable.

E8.3 (LO 1) Presented below are two independent situations.

Instructions

a. On January 6, Brumbaugh Co. sells merchandise on account to Pryor Group for €7,000, terms 2/10, n/30. On January 16, Pryor pays the amount due. Prepare the entries on Brumbaugh's books to record the sale and related collection. (Omit cost of goods sold entries.)

b. On January 10, Andrew Farley uses his Paltrow Co. credit card to purchase merchandise from Paltrow Co. for €9,000. On February 10, Farley is billed for the amount due of €9,000. On February 12, Farley pays €5,000 on the balance due. On March 10, Farley is billed for the amount due, including interest at 1% per month on the unpaid balance as of February 12. Prepare the entries on Paltrow's books related to the transactions that occurred on January 10, February 12, and March 10. (Omit cost of goods sold entries.)

Journalize receivables transactions.

E8.4 (LO 1, 2) At the beginning of the current period, Coe Ltd. had balances in Accounts Receivable of £200,000 and in Allowance for Doubtful Accounts of £9,000 (credit). During the period, it had net credit sales of £800,000 and collections of £763,000. It wrote off as uncollectible accounts receivable of £7,300. However, a £3,100 account previously written off as uncollectible was recovered before the end of the current period. Uncollectible accounts are estimated to total £25,000 at the end of the period. (Omit cost of goods sold entries.)

Instructions

a. Prepare the entries to record sales and collections during the period.

b. Prepare the entry to record the write-off of uncollectible accounts during the period.

c. Prepare the entries to record the recovery of the uncollectible account during the period.

d. Prepare the entry to record bad debt expense for the period.

e. Determine the ending balances in Accounts Receivable and Allowance for Doubtful Accounts.

f. What is the net realizable value of the receivables at the end of the period?

Journalize entries to record allowance for doubtful accounts using two different bases.

E8.5 (LO 2) The ledger of Costello Company at the end of the current year shows Accounts Receivable $110,000, Sales Revenue $840,000, and Sales Returns and Allowances $20,000.

Instructions

a. If Costello uses the direct write-off method to account for uncollectible accounts, journalize the adjusting entry at December 31, assuming Costello determines that L. Dole's $1,400 balance is uncollectible.

b. If Allowance for Doubtful Accounts has a credit balance of $2,100 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be 10% of accounts receivable.

c. If Allowance for Doubtful Accounts has a debit balance of $200 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be 6% of accounts receivable.

Determine bad debt expense, and prepare the adjusting entry.

E8.6 (LO 2) Min Yachts has accounts receivable of 95,400 at March 31, 2025 (amounts in thousands). Credit terms are 2/10, n/30. At March 31, 2025, there is a 2,100 credit balance in Allowance for Doubtful Accounts prior to adjustment. The company uses the percentage-of-receivables basis for estimating uncollectible accounts. The company's estimates of bad debts are as shown below.

Age of Accounts	Balance, March 31 2025	Balance, March 31 2024	Estimated Percentage Uncollectible
Current	₩65,000	₩75,000	2%
1–30 days past due	12,900	8,000	5
31–90 days past due	10,100	2,400	30
Over 90 days past due	7,400	1,100	50
	₩95,400	₩86,500	

Instructions

a. Determine the total estimated uncollectibles as of March 31, 2025.

b. Prepare the adjusting entry at March 31, 2025, to record bad debt expense.

c. Discuss the implications of the changes in the aging schedule from 2024 to 2025.

Journalize write-off and recovery.

E8.7 (LO 2) At December 31, 2024, Blanda Creations had a credit balance of €15,000 in Allowance for Doubtful Accounts. During 2025, Blanda wrote off accounts totaling €11,000. One of those accounts (€1,800) was later collected. At December 31, 2025, an aging schedule indicated that the balance in Allowance for Doubtful Accounts should be €19,000.

Instructions

Prepare journal entries to record the 2025 transactions of Blanda.

Journalize percentage-of-receivables basis, write-off, recovery.

E8.8 (LO 2) On December 31, 2025, Ling Industries estimated that 2% of its net accounts receivable of ¥450,000 will become uncollectible (amounts in thousands). The company recorded this amount as an addition to Allowance for Doubtful Accounts. The allowance account had a zero balance before adjustment at December 31, 2025. On May 11, 2026, Ling determined that the Jeff Shoemaker account was uncollectible and wrote off ¥1,100. On June 12, 2026, Shoemaker paid the amount previously written off.

Instructions

Prepare the journal entries on December 31, 2025, May 11, 2026, and June 12, 2026.

Journalize entries for the sale of accounts receivable.

E8.9 (LO 2) Presented below are two independent situations.

Instructions

a. On March 3, Kitselman Appliances sells $650,000 of its receivables to Ervay Factors Inc. Ervay Factors assesses a finance charge of 3% of the amount of receivables sold. Prepare the entry on Kitselman Appliances' books to record the sale of the receivables.

b. On May 10, Fillmore Company sold merchandise for $3,000 and accepted the customer's America Bank MasterCard. America Bank charges a 4% service charge for credit card sales. Prepare the entry on Fillmore Company's books to record the sale of merchandise.

Journalize entries for credit card sales.

E8.10 (LO 2) Presented as follows are two independent situations.

Instructions

a. On April 2, Jennifer Elston uses her **IKEA** (SWE) credit card to purchase merchandise from an IKEA store for €1,500. On May 1, Elston is billed for the €1,500 amount due. Elston pays €500

on the balance due on May 3. Elston receives a bill dated June 1 for the amount due, including interest at 1.0% per month on the unpaid balance as of May 3. Prepare the entries on IKEA's books related to the transactions that occurred on April 2, May 3, and June 1.

b. On July 4, Dupré Restaurant accepts a Visa card for a €200 dinner bill. Visa charges a 2% service fee. Prepare the entry on Dupré's books related to this transaction.

Journalize credit card sales.

E8.11 (LO 2) Colaw Stores accepts both its own and national credit cards. During the year, the following selected summary transactions occurred (NT$ in thousands).

Jan. 15	Made Colaw credit card sales totaling NT$18,000. (There were no balances prior to January 15.)
20	Made Visa credit card sales (service charge fee 2%) totaling NT$4,500.
Feb. 10	Collected NT$10,000 on Colaw credit card sales.
15	Added finance charges of 1.5% to Colaw credit card account balances.

Instructions

Journalize the transactions for Colaw Stores.

Journalize entries for notes receivable transactions.

E8.12 (LO 3) Chang Supply has the following transactions related to notes receivable during the last 2 months of 2025. The company does not make entries to accrue interest except at December 31.

Nov. 1	Loaned HK$300,000 cash to Manny Shin on a 12 month, 10% note.
Dec. 11	Sold goods to Malcolm Inc., receiving a HK$67,500, 90-day, 8% note.
16	Received a HK$400,000, 180 day, 9% note in exchange for Joe Fernetti's outstanding accounts receivable.
31	Accrued interest revenue on all notes receivable.

Instructions

a. Journalize the transactions for Chang Supply. (Ignore cost of goods sold.)

b. Record the collection of the Shin note at its maturity in 2026.

Journalize entries for notes receivable.

E8.13 (LO 3) Record the following transactions for Redeker Group in the general journal.

2025	
May 1	Received a €9,000, 12-month, 10% note in exchange for Mark Chamber's outstanding accounts receivable.
Dec. 31	Accrued interest on the Chamber note.
Dec. 31	Closed the interest revenue account.
2026	
May 1	Received principal plus interest on the Chamber note. (No interest has been accrued in 2026.)

Prepare entries for note receivable transactions.

E8.14 (LO 3) Vandiver Company had the following select transactions.

Apr. 1, 2025	Accepted Goodwin Company's 12-month, 6% note in settlement of a $30,000 account receivable.
July 1, 2025	Loaned $25,000 cash to Thomas Slocombe on a 9-month, 10% note.
Dec. 31, 2025	Accrued interest on all notes receivable.
Apr. 1, 2026	Received principal plus interest on the Goodwin note.
Apr. 1, 2026	Thomas Slocombe dishonored its note; Vandiver expects it will eventually collect.

Instructions

Prepare journal entries to record the transactions. Vandiver prepares adjusting entries once a year on December 31.

Journalize entries for dishonor of notes receivable.

E8.15 (LO 3) On May 2, Ling Ltd. lends ¥9,000 to Chen, Inc., issuing a 6-month, 7% note (¥ in thousands). At the maturity date, November 2, Chen indicates that it cannot pay.

Instructions

a. Prepare the entry to record the issuance of the note.

b. Prepare the entry to record the dishonor of the note, assuming that Ling expects collection will occur.

c. Prepare the entry to record the dishonor of the note, assuming that Ling does not expect collection in the future.

Prepare a statement of financial position presentation of receivables.

E8.16 (LO 4) Eileen Corp. had the following balances in receivable accounts at October 31, 2025 (in thousands): Allowance for Doubtful Accounts $52, Accounts Receivable $2,910, Other Receivables $189, and Notes Receivable $1,353.

Instructions

Prepare the statement of financial position presentation of Eileen Corp.'s receivables in good form.

Compute accounts receivable turnover and average collection period.

E8.17 (LO 4) Laskova A/S had accounts receivable of €100,000 on January 1, 2025. The only transactions that affected accounts receivable during 2025 were net credit sales of €1,000,000, cash collections of €920,000, and accounts written off of €30,000.

Instructions

a. Compute the ending balance of accounts receivable.

b. Compute the accounts receivable turnover for 2025.

c. Compute the average collection period in days.

Problems

Prepare journal entries related to bad debt expense.

P8.1 (LO 1, 2, 4) At December 31, 2024, Catu Medical reported the following information on its statement of financial position.

Accounts receivable	R$960,000
Less: Allowance for doubtful accounts	80,000

During 2025, the company had the following transactions related to receivables.

1. Sales on account	R$3,700,000

2. Sales returns and allowances	50,000
3. Collections of accounts receivable	2,810,000
4. Write-offs of accounts receivable deemed uncollectible	90,000
5. Recovery of bad debts previously written off as uncollectible	29,000

Instructions

a. Prepare the journal entries to record each of these five transactions. Assume that no cash discounts were taken on the collections of accounts receivable.

b. Enter the January 1, 2025, balances in Accounts Receivable and Allowance for Doubtful Accounts, post the entries to the two accounts (use T-accounts), and determine the balances.

b. Accounts receivable

R$1,710,000

ADA R$19,000

c. Prepare the journal entry to record bad debt expense for 2025, assuming that an aging of accounts receivable indicates that expected bad debts are R$115,000.

c. Bad debt expense R$96,000

d. Compute the accounts receivable turnover for 2025 assuming the expected bad debt information provided in (c).

Compute bad debt amounts.

P8.2 (LO 2) Writing Information related to Mingenback Ltd. for 2025 is summarized below.

Total credit sales	£2,500,000
Accounts receivable at December 31	875,000
Bad debts written off	33,000

Instructions

a. What amount of bad debt expense will Mingenback Ltd. report if it uses the direct write-off method of accounting for bad debts?

b. Assume that Mingenback Ltd. estimates its bad debt expense based on 6% of accounts receivable. What amount of bad debt expense will Mingenback record if it has an Allowance for Doubtful Accounts credit balance of £3,000?

b. £49,500

c. Assume the same facts as in (b), except that there is a £3,000 debit balance in Allowance for Doubtful Accounts. What amount of bad debt expense will Mingenback record?

d. What is the weakness of the direct write-off method of reporting bad debt expense?

Journalize entries to record transactions related to bad debts.

P8.3 (LO 2) Presented below is an aging schedule for Sycamore AG.

At December 31, 2025, the unadjusted balance in Allowance for Doubtful Accounts is a credit of €12,000.

Instructions

a. Journalize and post the adjusting entry for bad debts at December 31, 2025.

a. Bad debt expense €26,610

b. Journalize and post to the allowance account the following events and transactions in the year 2026.

1. On March 31, a €1,000 customer balance originating in 2025 is judged uncollectible.
2. On May 31, a check for €1,000 is received from the customer whose account was written off as uncollectible on March 31.

c. Journalize the adjusting entry for bad debts on December 31, 2026, assuming that the unadjusted balance in Allowance for Doubtful Accounts is a debit of €800 and the aging schedule indicates that total estimated bad debts will be €31,600.

c. Bad debt expense €32,400

Journalize transactions related to bad debts.

P8.4 (LO 2) Writing Ho Publishers, uses the allowance method to estimate uncollectible accounts receivable. The company produced the following aging of the accounts receivable at year-end (¥ in thousands).

Instructions

a. Calculate the total estimated bad debts based on the above information.

a. Tot. est. bad debts ¥9,400

b. Prepare the year-end adjusting journal entry to record the bad debts using the aged uncollectible accounts receivable determined in (a). Assume the current balance in Allowance for Doubtful Accounts is a ¥8,000 debit.

c. Of the above accounts, ¥5,000 is determined to be specifically uncollectible. Prepare the journal entry to write off the uncollectible account.

d. The company collects ¥5,000 subsequently on a specific account that had previously been determined to be uncollectible in (c). Prepare the journal entry(ies) necessary to restore the account and record the cash collection.

e. Comment on how your answers to (a)–(d) would change if Ho used 4% of **total** accounts receivable rather than aging the accounts receivable. What are the advantages to the company of aging the accounts receivable rather than applying a percentage to total accounts receivable?

Journalize entries to record transactions related to bad debts.

P8.5 (LO 2) Writing At December 31, 2025, the trial balance of Darby Antiques contained the following amounts before adjustment.

	Debit	Credit
Accounts Receivable	£385,000	
Allowance for Doubtful Accounts		£1,000
Sales Revenue		970,000

Instructions

a. Based on the information given, which method of accounting for bad debts is Darby using—the direct write-off method or the allowance method? How can you tell?

b. Prepare the adjusting entry at December 31, 2025, for bad debt expense, assuming an aging schedule indicates that £11,750 of accounts receivable will be uncollectible.

b. £10,750

c. Repeat part (b) assuming that instead of a credit balance there is a £1,000 debit balance in Allowance for Doubtful Accounts.

d. During the next month, January 2026, a £3,000 account receivable is written off as uncollectible. Prepare the journal entry to record the write-off.

e. Repeat part (d) assuming that Darby uses the direct write-off method instead of the allowance method in accounting for uncollectible accounts receivable.

f. What type of account is Allowance for Doubtful Accounts? How does it affect how accounts receivable is reported on the statement of financial position at the end of the accounting period?

Prepare entries for various credit card and notes receivable transactions.

P8.6 (LO 1, 2, 3, 4) Anping Enterprises closes its books on its July 31 year-end. The company does not make entries to accrue for interest except at its year-end. On June 30, the Notes Receivable account balance is NT$23,800 (amounts in thousands). Notes Receivable includes the following.

Date	Maker	Face Value	Term	Maturity Date	Interest Rate
April 21	Coote Inc.	NT$6,000	90 days	July 20	8%
May 25	Brady Co.	7,800	60 days	July 24	10%
June 30	BMG Corp.	10,000	6 months	December 31	6%

During July, the following transactions were completed.

July 5 Made sales of NT$4,500 on Anping credit cards.

14 Made sales of NT$600 on Visa credit cards. The credit card service charge is 3%.

20 Received payment in full from Coote Inc. on the amount due.

24 Received payment in full from Brady Co. on the amount due.

Instructions

a. Journalize the July transactions and the July 31 adjusting entry for accrued interest receivable. (Interest is computed using 360 days; omit cost of goods sold entries.)

b. Enter the balances at July 1 in the receivable accounts and post the entries to all of the receivable accounts. (Use T-accounts.)

b. A/R bal. NT$4,500

c. Show the statement of financial position presentation of the receivable accounts at July 31.

c. Tot. receivables NT$14,550

Prepare entries for various receivable transactions.

P8.7 (LO 1, 2, 3) On January 1, 2025, Harter Wholesalers had Accounts Receivable €139,000, Notes Receivable €25,000, and Allowance for Doubtful Accounts €13,200. The note receivable is from Willingham Company. It is a 4-month, 9% note dated December 31, 2024. Harter prepares financial statements annually at December 31. During the year, the following selected transactions occurred.

Jan. 5 Sold €20,000 of merchandise to Sheldon Company, terms n/15.

20 Accepted Sheldon's €20,000, 3-month, 8% note for balance due.

Feb. 18 Sold €8,000 of merchandise to Patwary Company and accepted Patwary's €8,000, 6-month, 9% note for the amount due.

Apr. 20 Collected Sheldon note in full.

30	Received payment in full from Willingham Company on the amount due.
May 25	Accepted Potter Inc.'s €6,000, 3-month, 7% note in settlement of a past-due balance on account.
Aug. 18	Received payment in full from Patwary on note due.
25	The Potter Inc. note was dishonored. Potter is not bankrupt; future payment is anticipated.
Sept. 1	Sold €12,000 of merchandise to Stanbrough Company and accepted a €12,000, 6-month, 10% note for the amount due.

Instructions

Journalize the transactions. (Omit cost of goods sold entries.)

Calculate and interpret various ratios.

P8.8 (LO 4) The amounts presented here are from recent annual reports of **Nike** (USA) and **adidas** (DEU). (All amounts are in millions.)

	Nike	adidas
Sales revenue	$37,403	€19,844
Allowance for doubtful accounts, beginning	30	189
Allowance for doubtful accounts, ending	214	267
Accounts receivable balance, beginning	4,302	2,814
Accounts receivable balance, ending	2,963	2,219

Instructions

Calculate the accounts receivable turnover and average collection period for both companies. Comment on the difference in their collection experiences.

Prepare financial statements.

P8.9 (LO 4) The adjusted trial balance of Yoon Imports for the year ended December 31, 2025, is as follows (amounts in thousands):

	Debit	Credit
Cash	¥ 6,400	
Accounts Receivable	2,700	
Notes Receivable	6,300	
Inventory	10,000	
Equipment	7,500	
Allowance for Doubtful Accounts		¥ 300
Accumulated Depreciation—Equipment		1,000
Notes Payable		1,100
Accounts Payable		600
Share Capital—Ordinary		16,000
Retained Earnings		12,000
Dividends	1,000	

	Debit	Credit
Sales Revenue		13,000
Interest Revenue		100
Cost of Goods Sold	8,000	
Salary and Wages Expense	1,400	
Rent Expense	700	
Bad Debt Expense	60	
Service Charge Expense	40	
	¥44,100	¥44,100

Instructions

Prepare an income statement, retained earnings statement, and a classified statement of financial position. The notes payable is due on January 10, 2026.

Net income ¥2,900

Comprehensive Accounting Cycle Review

ACR8 Victoria Ltd.'s statement of financial position at December 31, 2024, is presented below.

Victoria Ltd.
Statement of Financial Position
December 31, 2024

Inventory	£ 9,400	Share capital—ordinary	£20,000
Accounts receivable	19,780	Retained earnings	12,730
Allowance for doubtful accounts	(800)	Accounts payable	8,750
Cash	13,100		£41,480
	£41,480		

During January 2025, the following transactions occurred. Victoria uses the perpetual inventory method.

Jan. 1 Victoria accepted a 4-month, 8% note from Merando Company in payment of Merando's £1,200 account.

3 Victoria wrote off as uncollectible the accounts of Inwood Corporation (£450) and Goza Company (£280).

8 Victoria purchased £17,200 of inventory on account.

11 Victoria sold for £28,000 on account inventory that cost £19,600.

15 Victoria sold inventory that cost £700 to Mark Lauber for £1,000. Lauber charged this amount on his Visa First Bank card. The service fee charged Victoria by First Bank is 3%.

17 Victoria collected £22,900 from customers on account.

21 Victoria paid £14,300 on accounts payable.

24 Victoria received payment in full (£280) from Goza on the account written off on January 3.

27 Victoria purchased supplies for £1,400 cash.

31 Victoria paid other operating expenses, £3,718.

Adjustment data:

1. Interest is recorded for the month on the note from January 1.
2. Bad debts are expected to be 6% of the January 31, 2025, accounts receivable.

3. A count of supplies on January 31, 2025, reveals that £560 remains unused.

Instructions

(You may want to set up T-accounts to determine ending balances.)

a. Prepare journal entries for the above transactions and the adjusting entries. (Include entries for cost of goods sold using the perpetual system.)

b. Prepare an adjusted trial balance at January 31, 2025.

c. Prepare an income statement and a retained earnings statement for the month ending January 31, 2025, and a classified statement of financial position as of January 31, 2025.

Data Analytics in Action

Using Data Visualization to Understand Accounts Receivable and Bad Debts over Time

DA8.1 Data visualization can be used to understand accounts receivable and bad debts.



Example: Many stakeholders are interested in bad debt information. For example, under transparency rules in the United States, cities, states, and other governments publicize financial data. Using data visualization, we can see trends in the data from the city of Austin, Texas, regarding energy revenue and bad debt, as the following chart shows.

The chart indicates a steady increase in bad debt expense as a percent of total revenue from 2008 to 2011, followed by a steep peak in 2014. The expense percentage declined sharply in 2015, followed by a slight increase in 2016 and a decline to the lowest level in 2019. Over the entire 12-year period, revenue increased steadily. However, the trend in revenue does not explain the spike in bad debt expense, so there is likely some other cause of the increase in bad debt expense from 2012 to 2013.

What conclusions can we make about the city of Austin's ability to collect amounts owed by energy customers? Except for the peak in 2013 and 2014, Austin appears to be efficient in collecting amounts due. While the highest percent uncollectible is 1.51%, this amount is relatively low compared to many industries, which experience higher rates of uncollectibility. Austin's lower bad debt expense rate may be due to the nature of the industry-providing service—viewed by most people as essential. Customers are more likely to pay their energy bills while foregoing payments to other obligations they may owe.

In this case, you will use the data to calculate the relationships of accounts receivable to revenue and assets, and prepare a combo column and line chart to visualize those relationships for each of the largest revenue-producing companies in the United States.

Go to the Wiley online course for complete case details and instructions.

Using Data Analytics to Understand Notes Receivable over Time



DA8.2 Banks have large loan portfolios that result from loans to customers. Analytics can help us understand the proportion of these notes receivables to the bank's total assets. For this case, you will use the assets section of **JPMorgan Chase**'s (USA) balance sheet (statement of financial position) for 2 years to (1) calculate the proportion of each asset as a percent of total assets for both years (this is often called common-size financial statements), (2) create pie charts, and (3) analyze the differences.

Go to the Wiley online course for complete case details and instructions.

Expand Your Critical Thinking

Financial Reporting Problem: CAF AG

CT8.1 CAF AG sells office equipment and supplies to many organizations in the city and surrounding area on contract terms of 2/10, n/30. In the past, over 75% of the credit customers have taken advantage of the discount by paying within 10 days of the invoice date.

The number of customers taking the full 30 days to pay has increased within the last year. Current indications are that less than 60% of the customers are now taking the discount. Bad debts as a percentage of gross credit sales have risen from the 2.5% provided in past years to about 4.5% in the current year.

The company's Finance Committee has requested more information on the collections of accounts receivable. The controller responded to this request with the report reproduced below.

CAF AG
Accounts Receivable Collections
May 31, 2025

The fact that some credit accounts will prove uncollectible is normal. Annual bad debt write-offs have been 2.5% of gross credit sales over the past 5 years. During the last fiscal year, this percentage increased to slightly less than 4.5%. The current Accounts Receivable balance is €1,400,000. The condition of this balance in terms of age and probability of collection is as follows.

Proportion of Total	Age Categories	Probability of Collection
60%	not yet due	98%
22%	less than 30 days past due	96%
9%	30 to 60 days past due	94%
5%	61 to 120 days past due	91%
$2\frac{1}{2}$ %	121 to 180 days past due	75%
$1\frac{1}{2}$%	over 180 days past due	30%

Allowance for Doubtful Accounts had a credit balance of €29,500 on June 1, 2024. CAF has provided for a monthly bad debt expense accrual during the current fiscal year based on the assumption that 4.5% of gross credit sales will be uncollectible. Total gross credit sales for the 2024–2025 fiscal year amounted to €2,800,000. Write-offs of bad accounts during the year totaled €102,000.

Instructions

a. Prepare an accounts receivable aging schedule for CAF using the age categories identified in the controller's report to the Finance Committee showing the following.
   1. The amount of accounts receivable outstanding for each age category and in total.
   2. The estimated amount that is uncollectible for each category and in total.

b. Compute the amount of the year-end adjustment necessary to bring Allowance for Doubtful Accounts to the balance indicated by the age analysis. Then prepare the necessary journal entry to adjust the accounting records.

c. In a recessionary environment with tight credit and high interest rates:

1. Identify steps CAF might consider to improve the accounts receivable situation.
2. Then evaluate each step identified in terms of the risks and costs involved.

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT8.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information in these financial statements, compute the following ratios for each company for the most recent fiscal year shown. (Assume all sales are credit sales and that all receivables are trade receivables.)
   1. Accounts receivable turnover.
   2. Average collection period for receivables.

b. What conclusions about managing accounts receivable can you draw from these data?

Real-World Focus

CT8.3 **Purpose:** To learn more about factoring.

Instructions

Search the Internet under "commercial capital factoring" and then go to the corresponding **Commercial Capital LLC** website. Click on **Invoice Factoring** and answer the following questions.

a. What are some of the benefits of factoring?

b. What is the range of the percentages of the typical discount rate?

c. If a company factors its receivables, what percentage of the value of the receivables can it expect to receive from the factor in the form of cash, and how quickly will it receive the cash?

Decision-Making Across the Organization

CT8.4 Hilda and Tim Piwek own Campus Fashions. From its inception, Campus Fashions has sold merchandise on either a cash or credit basis, but no credit cards have been accepted. During the past several months, the Piweks have begun to question their sales policies. First, they have lost some sales because of refusing to accept credit cards. Second, representatives of two metropolitan banks have been persuasive in almost convincing them to accept their national credit cards. One bank, City National Bank, has stated that its credit card fee is 4%.

The Piweks decide that they should determine the cost of carrying their own credit sales. From the accounting records of the past 3 years, they accumulate the following data (amounts in thousands).

	2025	2024	2023
Net credit sales	NT$500,000	NT$650,000	NT$400,000
Collection agency fees for slow-paying customers	2,450	2,500	2,300
Salary of part-time accounts receivable clerk	4,100	4,100	4,100

Credit and collection expenses as a percentage of net credit sales are uncollectible accounts 1.6%, billing and mailing costs 0.5%, and credit investigation fee on new customers 0.15%.

Hilda and Tim also determine that the average accounts receivable balance outstanding during the year is 5% of net credit sales. The Piweks estimate that they could earn an average of 8% annually on cash invested in other business opportunities.

Instructions

With the class divided into groups, answer the following.

a. Prepare a table showing, for each year, total credit and collection expenses in New Taiwan dollars and as a percentage of net credit sales.

b. Determine the net credit and collection expense in New Taiwan dollars and as a percentage of sales after considering the revenue not earned from other investment opportunities.

c. Discuss both the financial and non-financial factors that are relevant to the decision.

Communication Activity

CT8.5 Lily Pao, a friend of yours, overheard a discussion at work about changes her employer wants to make in accounting for uncollectible accounts. Lily knows little about accounting, and she asks you to help make sense of what she heard. Specifically, she asks you to explain the differences between the percentage-of-receivables and the direct write-off methods for uncollectible accounts.

Instructions

In one page (or less), explain to Lily the two methods of accounting for uncollectibles. Be sure to discuss differences among these methods.

Ethics Case

CT8.6 The controller of Diaz Fashions believes that the yearly allowance for doubtful accounts for Diaz should be 2% of its accounts receivable balance at the end of the year. The president of Diaz, nervous that the shareholders might expect the company to sustain its 10% growth rate, suggests that the controller increase the allowance for doubtful accounts to 4%. The president thinks that the lower net income, which reflects a lower growth rate, will be a more sustainable rate for Diaz.

Instructions

a. Who are the stakeholders in this case?

b. Does the president's request pose an ethical dilemma for the controller?

c. Should the controller be concerned with Diaz's growth rate? Explain your answer.

A Look at U.S. GAAP

> **LEARNING OBJECTIVE 5**
>
> Compare the accounting for receivables under IFRS and U.S. GAAP.

The basic accounting and reporting issues related to the recognition, measurement, and disposition of receivables are essentially the same between IFRS and GAAP.

Key Points

Following are the key similarities and differences between GAAP and IFRS as related to the accounting for receivables.

Similarities

- The recording of accounts receivable, recognition of sales returns and allowances and sales discounts, and the allowance method to record bad debts are the same between IFRS and GAAP.
- Both IFRS and GAAP often use the term impairment to indicate that a receivable or a percentage of receivables may not be collected.
- The FASB and IASB have worked to implement fair value measurement (the amount they currently could be sold for) for financial instruments, such as receivables. Both Boards have faced bitter opposition from various factions.

Differences

- Although IFRS implies that receivables with different characteristics should be reported separately, there is no standard that mandates this segregation.
- IFRS and GAAP differ in the approach to estimating uncollectible accounts on receivables with a significant financing component (e.g., notes receivable). Under IFRS, long-term receivables that have not experienced a deterioration in credit quality after origination are estimated based on expected losses over the next 12 months. For long-term receivables that experience a credit quality decline, IFRS estimates uncollectible accounts based on lifetime expected losses. Under GAAP, only the second approach is used.
- IFRS and GAAP differ in the criteria used to determine how to record a factoring transaction. IFRS uses a combination approach focused on risks and rewards and loss of control. GAAP uses loss of control as the primary criterion. In addition, IFRS permits partial derecognition of receivables; GAAP does not.

GAAP Practice

GAAP Self-Test Questions

1. Under GAAP, receivables are reported on the balance sheet (statement of financial position) at:

a. gross amount.

b. gross amount less allowance for doubtful accounts.

c. historical cost.

d. replacement cost.

Answer

2. Which of the following statements is **false**?

a. Receivables include equity securities purchased by the company.

b. Receivables include credit card receivables.

c. Receivables include amounts owed by employees as a result of company loans to employees.

d. Receivables include amounts resulting from transactions with customers.

Answer

3. In recording a factoring transaction:

a. IFRS focuses on loss of control.

b. GAAP focuses on loss of control and risks and rewards.

c. IFRS and GAAP allow partial derecognition.

d. IFRS allows partial derecognition.

Answer

4. Under IFRS:

a. the entry to record estimated uncollectible accounts is the same as GAAP.

b. all impairments should be debited to Accounts Receivable.

c. it is always acceptable to use the direct write-off method.

d. all receivables are recorded at fair value.

Answer

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP8.1 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Use the company's financial statements and notes to the financial statements to answer the following questions.

a. Calculate the accounts receivable turnover and average collection period for 2020 and 2019. Accounts receivable at September 29, 2018, was $23,186 (in millions).

b. What conclusions can you draw from the information in part (a)?

Appendix G
Subsidiary Ledgers and Special Journals

Appendix Preview

A reliable information system is a necessity for any company. Whether companies use pen, pencil, or computers in maintaining accounting records, certain principles and procedures apply. The purpose of this appendix is to explain and illustrate two components of an accounting information system: subsidiary ledgers and special journals.

Appendix Outline

LEARNING OBJECTIVES	REVIEW
LO 1 Describe the nature and purpose of a subsidiary ledger.	• Subsidiary ledger example • Advantages of subsidiary ledgers
LO 2 Record transactions in special journals.	• Sales journal • Cash receipts journal • Purchases journal • Cash payments journal • Effects of special journals • Cybersecurity

G.1 Subsidiary Ledgers

LEARNING OBJECTIVE 1

Describe the nature and purpose of a subsidiary ledger.

Imagine a business that has several thousand charge (credit) customers and shows the transactions with these customers in only one general ledger account—Accounts Receivable. It would be nearly impossible to determine the balance owed by an individual customer at any specific time.

Similarly, the amount payable to one creditor would be difficult to locate quickly from a single Accounts Payable account in the general ledger.

Instead, companies use subsidiary ledgers to keep track of individual balances.

- A **subsidiary ledger** is a group of accounts with a common characteristic (for example, all accounts receivable).
- It is an addition to and an expansion of the general ledger.
- The subsidiary ledger frees the general ledger from the details of individual balances.

Two common subsidiary ledgers are as follows.

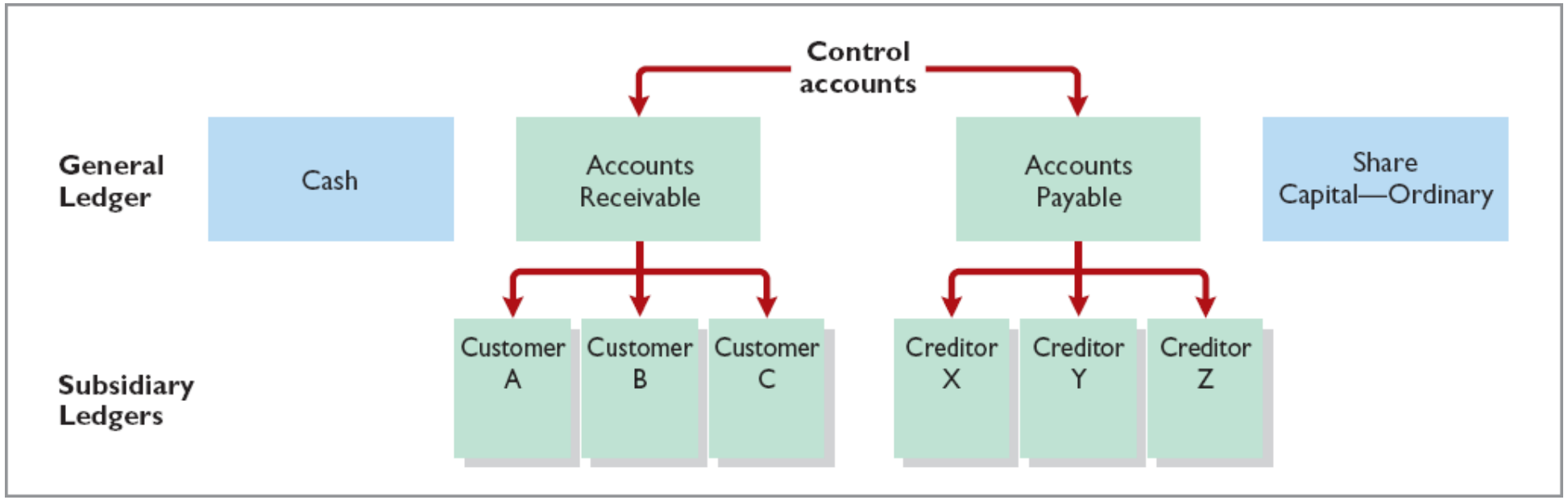
1. The **accounts receivable** (or **customers'**) **subsidiary ledger**, which collects transaction data of individual customers.
2. The **accounts payable** (or **creditors'**) **subsidiary ledger**, which collects transaction data of individual creditors.

In each of these subsidiary ledgers, companies usually arrange individual accounts in alphabetical order.

A general ledger account summarizes the detailed data from a subsidiary ledger. For example, the detailed data from the accounts receivable subsidiary ledger are summarized in Accounts Receivable in the general ledger. The general ledger account that summarizes subsidiary ledger data is called a **control account**.

Illustration G.1 presents an overview of the relationship of subsidiary ledgers to the general ledger. There, the general ledger control accounts and subsidiary ledger accounts are in green. Note that Cash and Share Capital—Ordinary in this illustration are not control accounts because there are no subsidiary ledger accounts related to these accounts.

ILLUSTRATION G.1 Relationship of general ledger and subsidiary ledgers



At the end of an accounting period, each general ledger control account balance must equal the composite balance of the individual accounts in the related subsidiary ledger. For example, the balance in Accounts Payable in Illustration G.1 must equal the total of the subsidiary balances of Creditors X + Y + Z.

Subsidiary Ledger Example

Illustration G.2 lists credit sales and collections on account for Pujols Company.

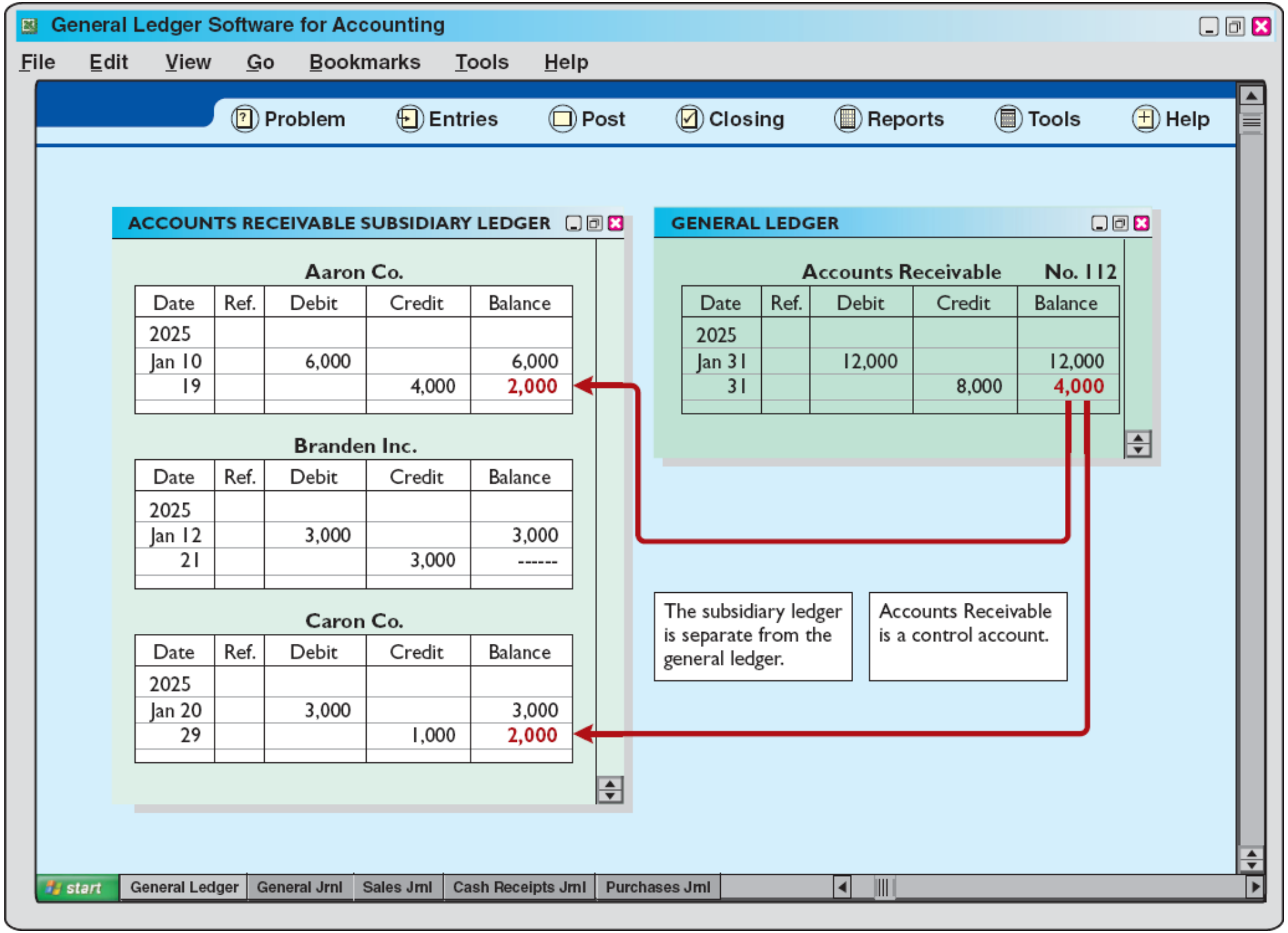
ILLUSTRATION G.2 Sales and collection transactions

Credit Sales			Collections on Account		
Jan. 10	Aaron Co.	$ 6,000	Jan. 19	Aaron Co.	$4,000
12	Branden Inc.	3,000	21	Branden Inc.	3,000
20	Caron Co.	3,000	29	Caron Co.	1,000
		$12,000			$8,000

Illustration G.3 provides an example of a control account and subsidiary ledger for Pujols Company. (Due to space considerations, the explanation column in these accounts is not shown in this and subsequent illustrations.) Illustration G.3 is based on the transactions listed in Illustration G.2.

Pujols can reconcile the total debits ($12,000) and credits ($8,000) in Accounts Receivable in the general ledger to the detailed debits and credits in the subsidiary accounts. Also, the balance of $4,000 in the control account agrees with the total of the balances in the individual accounts (Aaron Co. $2,000 + Branden Inc. $0 + Caron Co. $2,000) in the subsidiary ledger.

ILLUSTRATION G.3 Relationship between general and subsidiary ledgers


General Ledger Software for Accounting
File Edit View Go Bookmarks Tools Help
Problem Entries Post Closing Reports Tools Help
ACCOUNTS RECEIVABLE SUBSIDIARY LEDGER
Aaron Co.
Date | Ref. | Debit | Credit | Balance
2025
Jan 10 | 6,000 | 6,000
19 | 4,000 | 2,000
Branden Inc.
Date | Ref. | Debit | Credit | Balance
2025
Jan 12 | 3,000 | 3,000
21 | 3,000 | ------
Caron Co.
Date | Ref. | Debit | Credit | Balance
2025
Jan 20 | 3,000 | 3,000
29 | 1,000 | 2,000
GENERAL LEDGER
Accounts Receivable No. 112
Date | Ref. | Debit | Credit | Balance
2025
Jan 31 | 12,000 | 12,000
31 | 8,000 | 4,000
The subsidiary ledger is separate from the general ledger.
Accounts Receivable is a control account.
start
General Ledger
General Jrnl
Sales Jrnl
Cash Receipts Jrnl
Purchases Jrnl

- As Illustration G.3 shows, companies make monthly postings to the control accounts in the general ledger. This practice allows them to prepare monthly financial statements.
- Companies post to the individual accounts in the subsidiary ledger daily. Daily posting ensures that account information is current. This enables the company to monitor credit limits, bill customers, and answer inquiries from customers about their account balances.

Advantages of Subsidiary Ledgers

Subsidiary ledgers have several advantages:

1. **They show in a single account transactions affecting one customer or one creditor,** thus providing up-to-date information on specific account balances.
2. **They free the general ledger of excessive details.** As a result, a trial balance of the general ledger does not contain vast numbers of individual account balances.
3. **They help locate errors in individual accounts** by reducing the number of accounts in one ledger and by using control accounts.
4. **They make possible a division of labor** in posting. One employee can post to the general ledger while someone else posts to the subsidiary ledgers.

G.2 Special Journals

> **LEARNING OBJECTIVE 2**
>
> Record transactions in special journals.

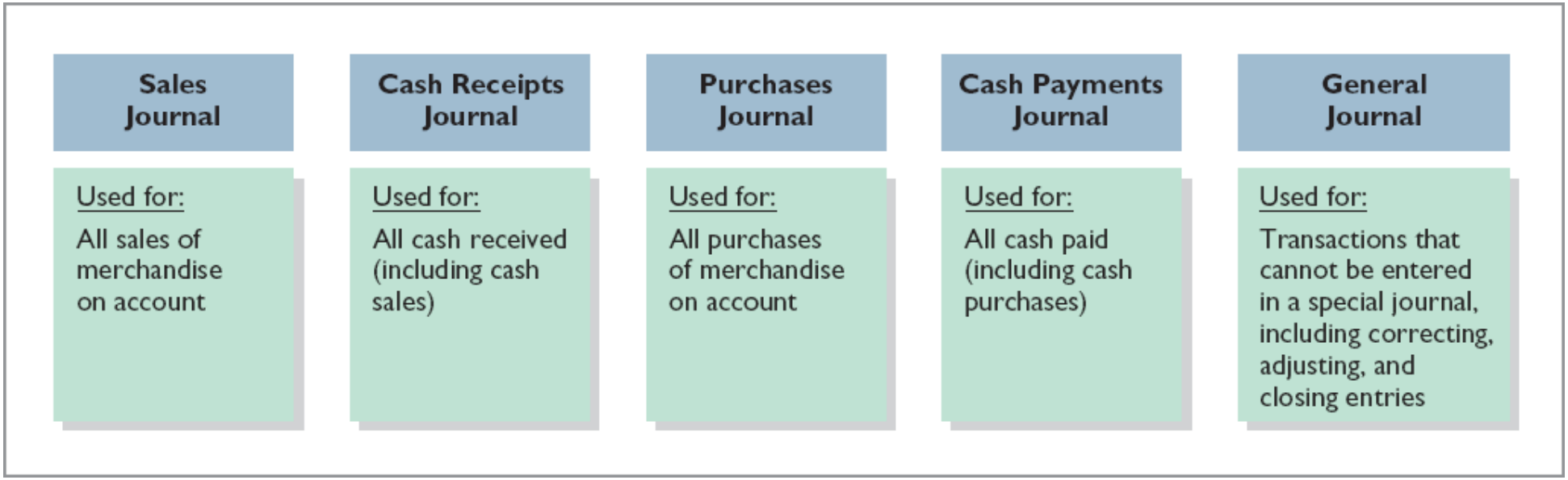
So far, you have learned to journalize transactions in a two-column general journal and post each entry to the general ledger. This procedure is satisfactory in only very small companies. To expedite journalizing and posting, most companies use special journals **in addition to the general journal**.

- Companies use **special journals** to record similar types of transactions. Examples are all sales of merchandise on account or all cash receipts.
- The types of transactions that occur frequently in a company determine what special journals the company uses.

Most merchandising companies record daily transactions using the journals shown in **Illustration G.4** (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Postings are also made daily to individual ledger accounts in the inventory subsidiary ledger to maintain a perpetual inventory.**

ILLUSTRATION G.4 Use of special journals and the general journal



If a transaction cannot be recorded in a special journal, the company records it in the general journal. For example, if a company had special journals for only the four types of transactions listed above, it would record purchase returns and allowances that do not affect cash in the general journal. Similarly, **correcting, adjusting, and closing entries are recorded in the general journal**. In some situations, companies might use special journals other than those listed above. For example, when sales returns and allowances that do not affect cash are frequent, a company might use a special journal to record these transactions.

- Special journals **permit greater division of labor** because several people can record entries in different journals at the same time. For example, one employee may journalize all cash receipts, and another may journalize all credit sales.
- Also, the use of special journals **reduces the time needed to complete the posting process**. With special journals, companies may post some accounts monthly instead of daily, as we will illustrate later in the appendix.

On the following pages, we discuss the four special journals shown in Illustration G.4.

Sales Journal

In the **sales journal**, companies record **sales of merchandise on account**. Cash sales of merchandise go in the cash receipts journal. Credit sales of assets other than merchandise go in the general journal.

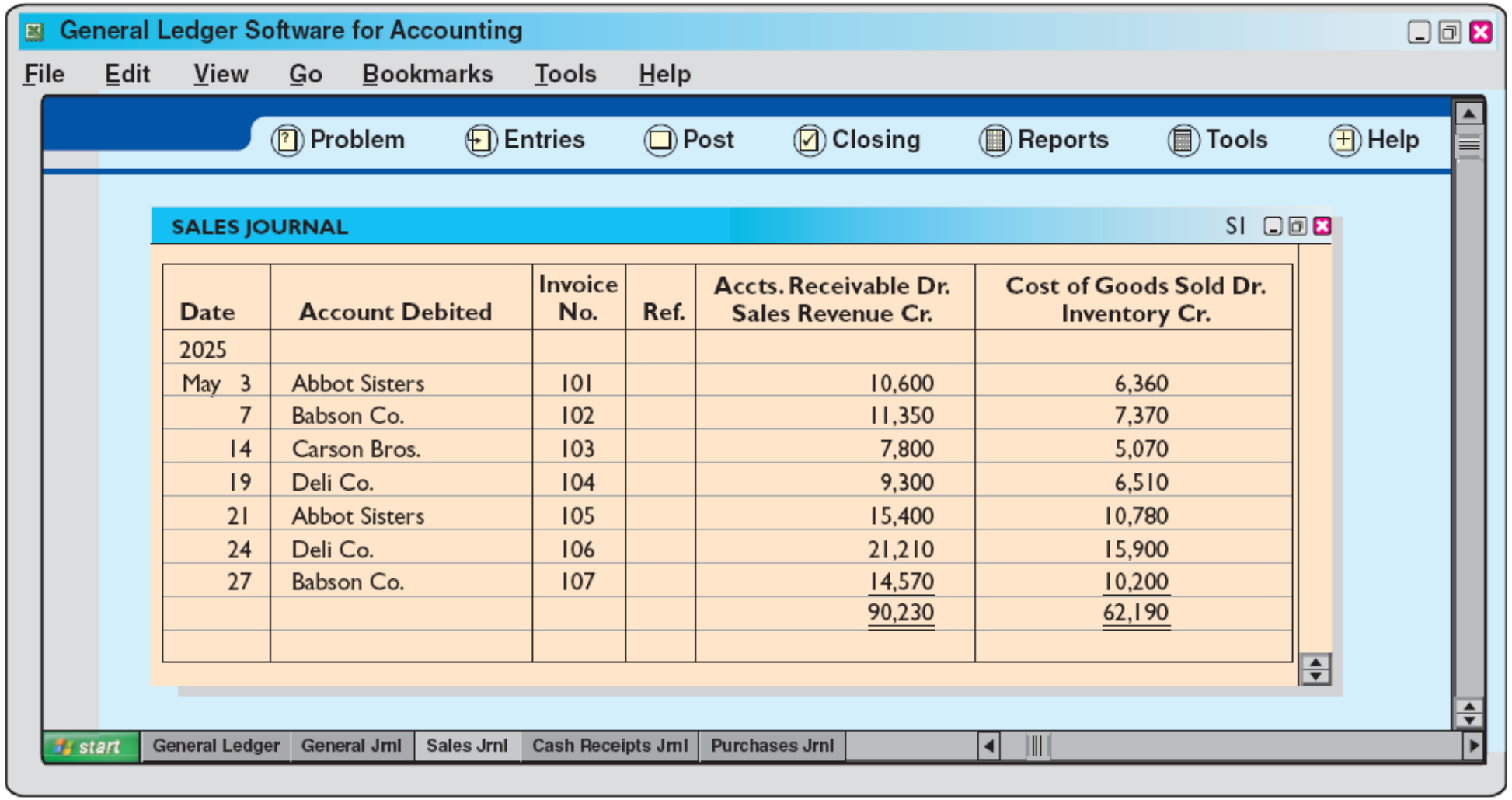
Journalizing Credit Sales

To demonstrate use of a sales journal, we will use data for Karns Wholesale Supply, which uses a **perpetual inventory system**. Under this system, each entry in the sales journal results in one entry **at selling price** and another entry **at cost**. The entry at selling price is a debit to Accounts

Receivable (a control account) and a credit of equal amount to Sales Revenue. The entry at cost is a debit to Cost of Goods Sold and a credit of equal amount to Inventory (a control account).

Using a sales journal with two amount columns, the company can show on only one line a sales transaction at both selling price and cost. Illustration G.5 shows this two-column sales journal of Karns Wholesale Supply, using assumed credit sales transactions, for sales invoices 101–107.

ILLUSTRATION G.5 Journalizing the sales journal—perpetual inventory system



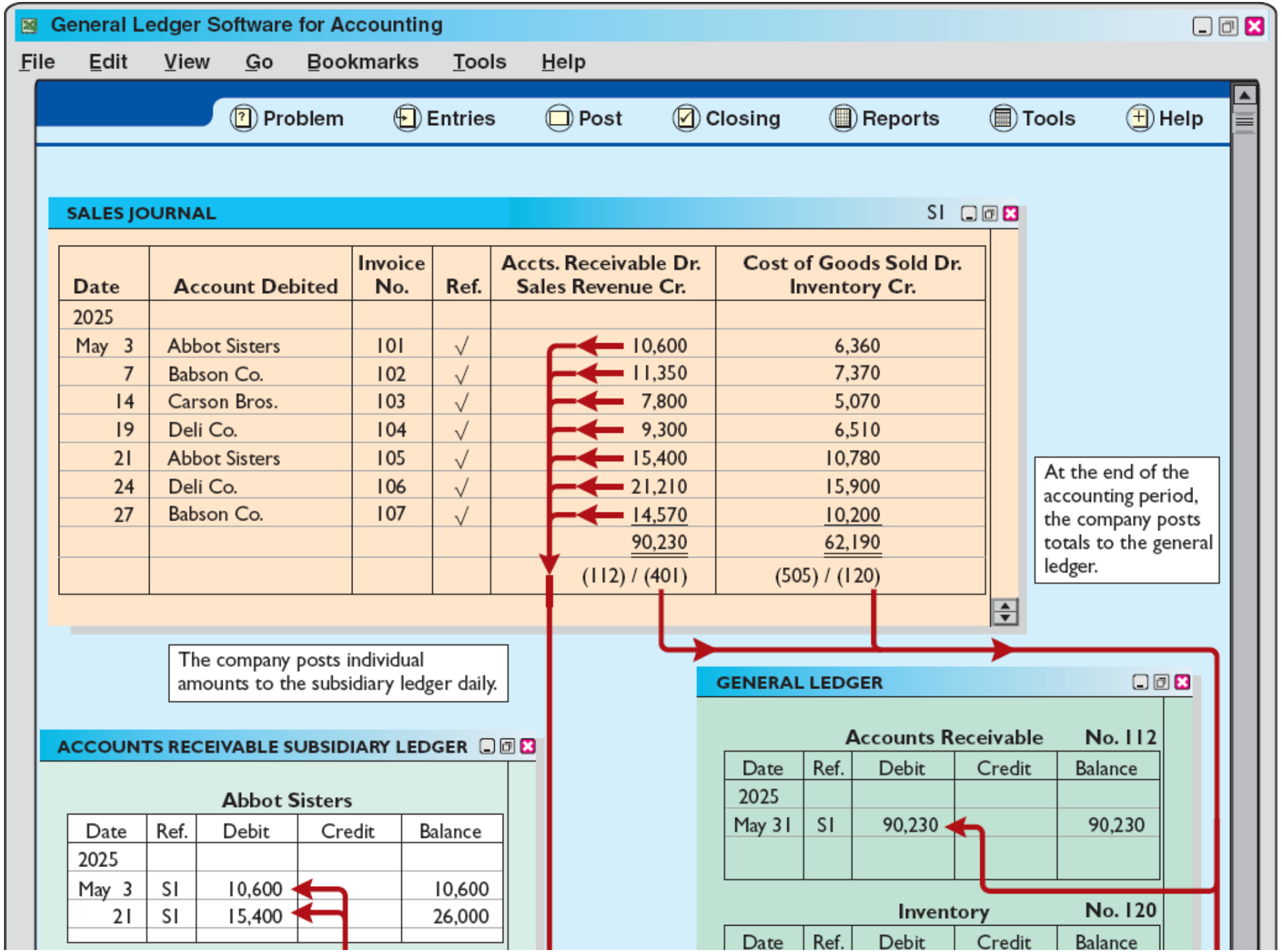
Date	Account Debited	Invoice No.	Ref.	Accts. Receivable Dr. Sales Revenue Cr.	Cost of Goods Sold Dr. Inventory Cr.
2025					
May 3	Abbot Sisters	101		10,600	6,360
7	Babson Co.	102		11,350	7,370
14	Carson Bros.	103		7,800	5,070
19	Deli Co.	104		9,300	6,510
21	Abbot Sisters	105		15,400	10,780
24	Deli Co.	106		21,210	15,900
27	Babson Co.	107		14,570	10,200
				90,230	62,190

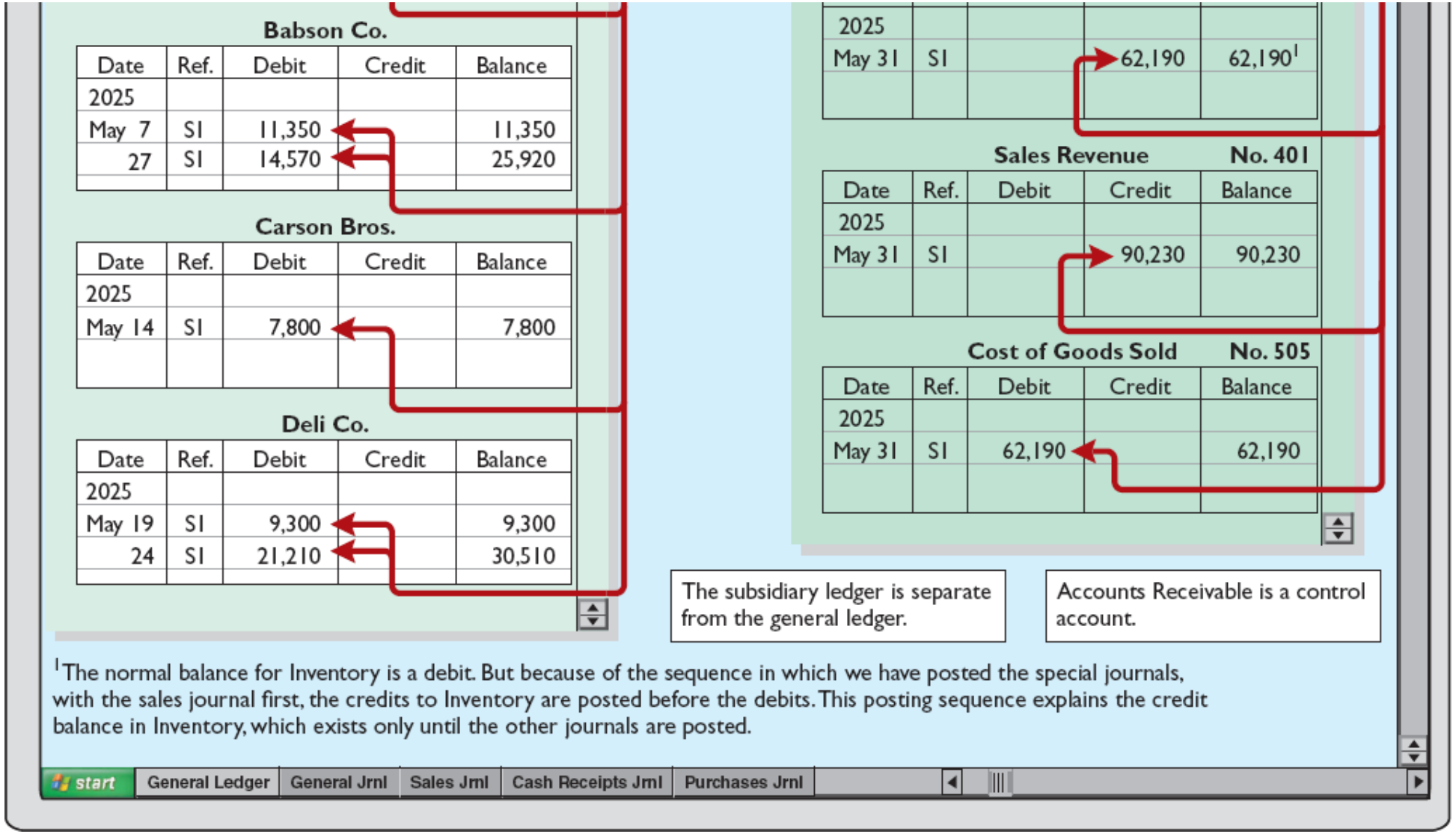
Note that, unlike the general journal, an explanation is not required for each entry in a special journal. Also, the use of prenumbered invoices ensures that all invoices are journalized and no invoices are duplicated. Finally, the reference (Ref.) column is not used in journalizing. It is used in posting the sales journal, as explained in the next section.

Posting the Sales Journal

Companies make daily postings from the sales journal **to the individual accounts receivable** in the subsidiary ledger. Posting **to the general ledger** is done **monthly**. Illustration G.6 shows both the daily and monthly postings.

ILLUSTRATION G.6 Posting the sales journal


General Ledger Software for Accounting
File Edit View Go Bookmarks Tools Help
Problem Entries Post Closing Reports Tools Help
SALES JOURNAL
S1
Date | Account Debited | Invoice No. | Ref. | Accts. Receivable Dr. Sales Revenue Cr. | Cost of Goods Sold Dr. Inventory Cr.
2025
May 3 | Abbot Sisters | 101 | √ | 10,600 | 6,360
7 | Babson Co. | 102 | √ | 11,350 | 7,370
14 | Carson Bros. | 103 | √ | 7,800 | 5,070
19 | Deli Co. | 104 | √ | 9,300 | 6,510
21 | Abbot Sisters | 105 | √ | 15,400 | 10,780
24 | Deli Co. | 106 | √ | 21,210 | 15,900
27 | Babson Co. | 107 | √ | 14,570 | 10,200
90,230 | 62,190
(112) / (401) | (505) / (120)
At the end of the accounting period, the company posts totals to the general ledger.
The company posts individual amounts to the subsidiary ledger daily.
ACCOUNTS RECEIVABLE SUBSIDIARY LEDGER
Abbot Sisters
Date | Ref. | Debit | Credit | Balance
2025
May 3 | S1 | 10,600 | 10,600
21 | S1 | 15,400 | 26,000
GENERAL LEDGER
Accounts Receivable No. 112
Date | Ref. | Debit | Credit | Balance
2025
May 31 | S1 | 90,230 | 90,230
Inventory No. 120
Date | Ref. | Debit | Credit | Balance



A check mark (✓) is inserted in the reference column to indicate that the daily posting to the customer's account has been made. If the subsidiary ledger accounts were numbered, the account number would be entered in place of the check mark.

At the end of the month, Karns posts the column totals of the sales journal to the general ledger. Here, the column totals are posted as follows. From the selling-price column, a debit of $90,230 to Accounts Receivable (account No. 112), and a credit of $90,230 to Sales Revenue (account No. 401). From the cost column, a debit of $62,190 to Cost of Goods Sold (account No. 505), and a credit of $62,190 to Inventory (account No. 120).

Karns inserts the account numbers below the column totals to indicate that the postings have been made. In both the general ledger and subsidiary ledger accounts, the reference **S1** indicates that the posting came from page 1 of the sales journal.

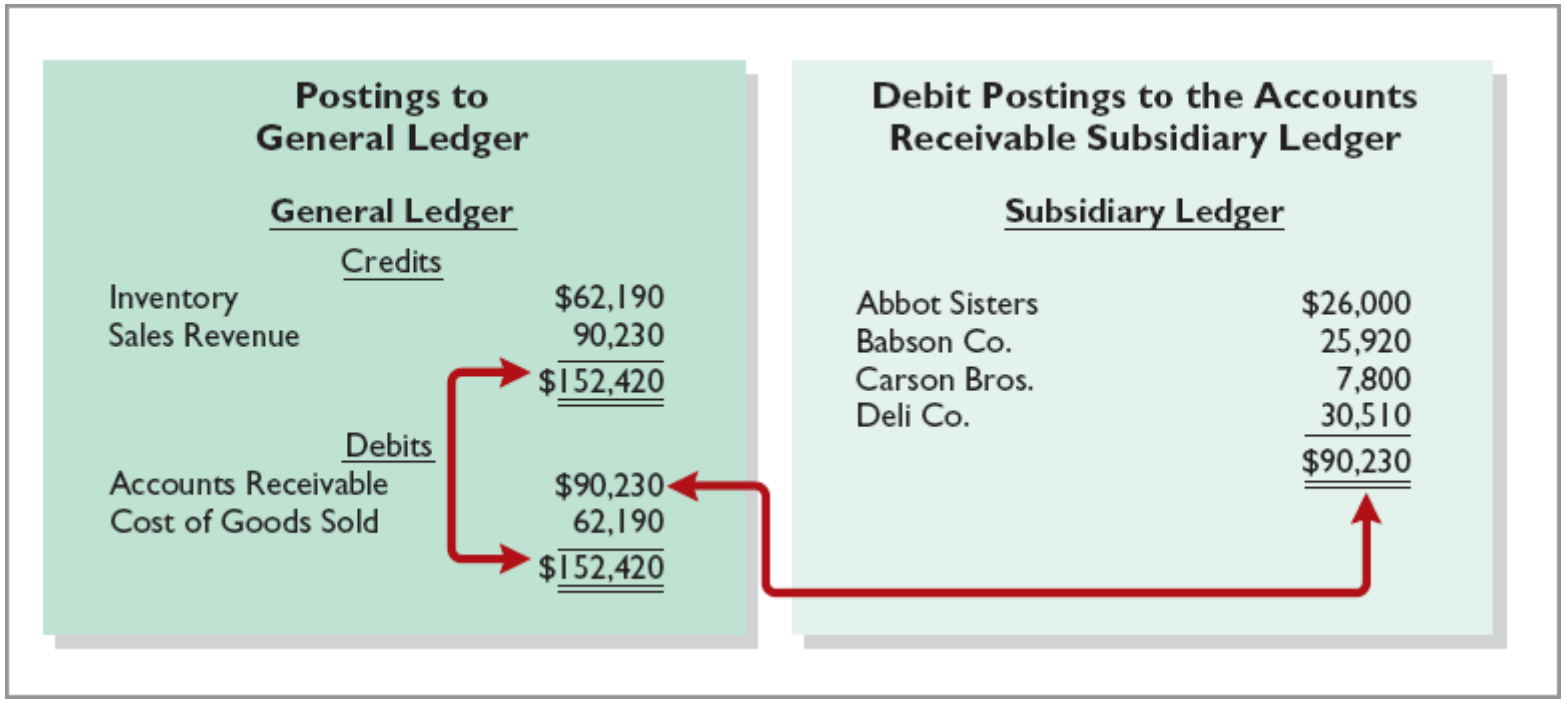
Proving the Ledgers

The next step is to "prove" the ledgers. To do so, Karns must determine two things:

1. The total of the general ledger debit balances must equal the total of the general ledger credit balances.
2. The sum of the subsidiary ledger balances must equal the balance in the control account.

Illustration G.7 shows the proof of the postings from the sales journal to the general and subsidiary ledgers.

ILLUSTRATION G.7 Proving the equality of the postings from the sales journal



Advantages of the Sales Journal

The use of a special journal to record sales on account has a number of advantages.

- The one-line entry for each sales transaction saves time. In the sales journal, it is not necessary to write out the four account titles for each transaction.
- Only totals, rather than individual entries, are posted to the general ledger. This saves posting time and reduces the possibilities of errors in posting.
- A division of labor results because one individual can take responsibility for the sales journal.

Cash Receipts Journal

In the **cash receipts journal**, companies record all receipts of cash. The most common types of cash receipts are cash sales of merchandise and collections of accounts receivable. Many other possibilities exist, such as receipt of money from bank loans and cash proceeds from disposal of equipment. A one- or two-column cash receipts journal would not have space enough for all possible cash receipt transactions. Therefore, companies use a multiple-column cash receipts journal.

Generally, a cash receipts journal includes the following columns: debit columns for Cash and Sales Discounts, and credit columns for Accounts Receivable, Sales Revenue, and "Other Accounts." Companies use the Other Accounts category when the cash receipt does not involve a cash sale or a collection of accounts receivable. Under a perpetual inventory system, each sales entry also is accompanied by an entry that debits Cost of Goods Sold and credits Inventory for the cost of the merchandise sold. **Illustration G.8** shows a six-column cash receipts journal.

ILLUSTRATION G.8 Journalizing and posting the cash receipts journal

Companies may use additional credit columns if these columns significantly reduce postings to a specific account. For example, a loan company receives thousands of cash collections from customers. Using separate credit columns for Loans Receivable and Interest Revenue, rather than the Other Accounts credit column, would reduce postings.

Journalizing Cash Receipts Transactions

To illustrate the journalizing of cash receipts transactions, we examine the May transactions of Karns Wholesale Supply. Collections from customers relate to the entries recorded in the sales journal in Illustration G.5. The entries in the cash receipts journal are based on the following cash receipts.

May	1	D. A. Karns makes an investment of $5,000 in the business.
	7	Cash sales of merchandise total $1,900 (cost, $1,240).
	10	Received a check for $10,388 from Abbot Sisters in payment of invoice No. 101 for $10,600 less a 2% discount.
	12	Cash sales of merchandise total $2,600 (cost, $1,690).
	17	Received a check for $11,123 from Babson Co. in payment of invoice No. 102 for $11,350 less a 2% discount.
	22	Received cash by signing a note for $6,000.
	23	Received a check for $7,644 from Carson Bros. in full for invoice No. 103 for $7,800 less a 2% discount.
	28	Received a check for $9,114 from Deli Co. in full for invoice No. 104 for $9,300 less a 2% discount.

Further information about the columns in the cash receipts journal is discussed below.

Debit Columns:

1. **Cash.** Karns enters in this column the amount of cash actually received in each transaction. The column total indicates the total cash receipts for the month.

2. **Sales Discounts.** Karns includes a Sales Discounts column in its cash receipts journal. By doing so, it does not need to enter sales discount items in the general journal. As a result, the cash receipts journal shows on one line the collection of an account receivable within the discount period.

Credit Columns:

3. **Accounts Receivable.** Karns uses the Accounts Receivable column to record cash collections on account. The amount entered here is the amount to be credited to the individual customer's account (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **A *subsidiary ledger* account is credited when the entry involves a collection of accounts receivable. A *general ledger* account is credited when the account is not shown in a special column (and an amount must be entered in the Other Accounts column). Otherwise, no account is shown in the "Account Credited" column.**

4. **Sales Revenue.** The Sales Revenue column records all cash sales of merchandise. Cash sales of other assets (plant assets, for example) are not reported in this column.
5. **Other Accounts.** Karns uses the Other Accounts column whenever the credit is other than to Accounts Receivable or Sales Revenue. For example, in the first entry, Karns enters $5,000 as a credit to Share Capital—Ordinary. This column is often referred to as the sundry accounts column.

Debit and Credit Column:

6. **Cost of Goods Sold and Inventory.** This column records debits to Cost of Goods Sold and credits to Inventory.

In a multi-column journal, generally only one line is needed for each entry. Debit and credit amounts for each line must be equal. When Karns journalizes the collection from Abbot Sisters on May 10, for example, three amounts are indicated. Note also that the Account Credited column identifies both general ledger and subsidiary ledger account titles. General ledger accounts are illustrated in the May 1 and May 22 entries. A subsidiary account is illustrated in the May 10 entry for the collection from Abbot Sisters.

When Karns has finished journalizing a multi-column journal, it totals the amount columns and compares the totals to prove the equality of debits and credits. **Illustration G.9** shows the proof of the equality of Karns's cash receipts journal.

Totaling the columns of a journal and proving the equality of the totals is called **footing** and **cross-footing** a journal.

ILLUSTRATION G.9 Proving the equality of the cash receipts journal

Posting the Cash Receipts Journal

Posting a multi-column journal (Illustration G.8) involves the following steps.

1. **At the end of the month**, the company posts all column totals, except for the Other Accounts total, to the account title(s) specified in the column heading (such as Cash or Accounts Receivable). The company then enters account numbers below the column totals to show that they

have been posted. For example, Karns has posted Cash to account No. 101, Accounts Receivable to account No. 112, Inventory to account No. 120, Sales Revenue to account No. 401, Sales Discounts to account No. 414, and Cost of Goods Sold to account No. 505.

2. The company **separately posts the individual amounts comprising the Other Accounts total** to the general ledger accounts specified in the Account Credited column. See, for example, the credit posting to Share Capital—Ordinary. The total amount of this column has not been posted. The symbol (X) is inserted below the total to this column to indicate that the amount has not been posted.
3. The individual amounts in a column, posted in total to a control account (Accounts Receivable, in this case), are posted **daily to the subsidiary ledger** account specified in the Account Credited column. See, for example, the credit posting of $10,600 to Abbot Sisters.

The symbol **CR**, used in both the subsidiary and general ledgers, identifies postings from the cash receipts journal.

Proving the Ledgers

After posting of the cash receipts journal is completed, Karns proves the ledgers. As shown in Illustration G.10, the general ledger totals agree. Also, the sum of the subsidiary ledger balances equals the control account balance.

ILLUSTRATION G.10 Proving the ledgers after posting the sales and the cash receipts journals

Purchases Journal

In the **purchases journal**, companies record all purchases of merchandise on account. Each entry in this journal results in a debit to Inventory and a credit to Accounts Payable. For example, consider the following credit purchase transactions for Karns Wholesale Supply in Illustration G.11.

ILLUSTRATION G.11 Credit purchase transactions

Date	Supplier	Amount
5/6	Jasper Manufacturing Inc.	$11,000
5/10	Eaton and Howe Inc.	7,200
5/14	Fabor and Son	6,900
5/19	Jasper Manufacturing Inc.	17,500
5/26	Fabor and Son	8,700
5/29	Eaton and Howe Inc.	12,600

Illustration G.12 shows the purchases journal for Karns Wholesale Supply (see **Helpful Hint**). When using a one-column purchases journal (as in Illustration G.12), a company cannot journalize other types of purchases on account or cash purchases in it. For example, if the company used the purchases journal in Illustration G.12, Karns would have to record credit purchases of equipment or supplies in the general journal. Likewise, all cash purchases would be entered in the cash payments journal.

> **HELPFUL HINT**
>
> **A single-column purchases journal needs only to be footed to prove the equality of debits and credits.**

Journalizing Credit Purchases of Merchandise

The journalizing procedure is similar to that for a sales journal.

- Companies make entries in the purchases journal from purchase invoices.
- In contrast to the sales journal, the purchases journal may not have an invoice number column because invoices received from different suppliers will not be in numerical sequence.
- To ensure that they record all purchase invoices, some companies consecutively number each invoice upon receipt and then use an internal document number column in the purchases journal.

The entries for Karns Wholesale Supply are based on the assumed credit purchases listed in Illustration G.11.

Posting the Purchases Journal

The procedures for posting the purchases journal are similar to those for the sales journal.

- In this case, Karns makes **daily** postings to the **accounts payable ledger** (see **Helpful Hint**).
- It makes **monthly** postings to Inventory and Accounts Payable in the general ledger.
- In both ledgers, Karns uses **P1** in the reference column to show that the postings are from page 1 of the purchases journal.

> **HELPFUL HINT**
>
> **Postings to subsidiary ledger accounts are done daily because it is often necessary to know a current balance for the subsidiary accounts.**

Proof of the equality of the postings from the purchases journal to both ledgers is shown in **Illustration G.13**.

Expanding the Purchases Journal

Some companies expand the purchases journal to include all types of purchases on account, not just merchandise. Instead of one column for inventory and accounts payable, they use a multiple-column format. This format usually includes a credit column for Accounts Payable and debit columns for purchases of Inventory, Supplies, and Other Accounts. **Illustration G.14** shows a multi-column purchases journal for Hanover Co. The posting procedures are similar to those shown earlier for posting the cash receipts journal. *For homework problems, assume the use of a single-column purchases journal unless instructed otherwise.*

ILLUSTRATION G.12 Journalizing and posting the purchases journal

ILLUSTRATION G.13 Proving the equality of the purchases journal

ILLUSTRATION G.14 Multi-column purchases journal

Cash Payments Journal

In a **cash payments (cash disbursements) journal**, companies record all disbursements of cash. Entries are made from prenumbered checks. Because companies make cash payments for various purposes, the cash payments journal has multiple columns. **Illustration G.15** shows a four-column journal.

ILLUSTRATION G.15 Journalizing and posting the cash payments journal

Journalizing Cash Payments Transactions

The procedures for journalizing transactions in this journal are similar to those for the cash receipts journal. Karns records each transaction on one line, and for each line there must be equal debit and credit amounts. The entries in the cash payments journal in Illustration G.15 are based on the following transactions for Karns Wholesale Supply.

May	1	Issued check No. 101 for $1,200 for the annual premium on a fire insurance policy.
	3	Issued check No. 102 for $100 in payment of freight when terms were FOB shipping point.
	8	Issued check No. 103 for $4,400 for the purchase of merchandise.
	10	Sent check No. 104 for $10,780 to Jasper Manufacturing Inc. in payment of May 6 invoice for $11,000 less a 2% discount.
	19	Mailed check No. 105 for $6,984 to Eaton and Howe Inc. in payment of May 10 invoice for $7,200 less a 3% discount.
	23	Sent check No. 106 for $6,831 to Fabor and Son in payment of May 14 invoice for $6,900 less a 1% discount.
	28	Sent check No. 107 for $17,150 to Jasper Manufacturing Inc. in payment of May 19 invoice for $17,500 less a 2% discount.
	30	Issued check No. 108 for $500 to D. A. Karns as a cash withdrawal for personal use.

Note that whenever Karns enters an amount in the Other Accounts column, it must identify a specific general ledger account in the Account Debited column. The entries for checks No. 101, 102, 103, and 108 illustrate this situation. Similarly, Karns must identify a subsidiary account in the Account Debited column whenever it enters an amount in the Accounts Payable column. See, for example, the entry for check No. 104.

After Karns journalizes the cash payments journal, it totals the columns. The totals are then balanced to prove the equality of debits and credits.

Posting the Cash Payments Journal

The procedures for posting the cash payments journal are similar to those for the cash receipts journal.

- Karns posts the amounts recorded in the Accounts Payable column individually to the subsidiary ledger and in total to the control account.
- It posts Inventory and Cash only in total at the end of the month.
- Transactions in the Other Accounts column are posted individually to the appropriate account(s) affected. The company does not post totals for the Other Accounts column.

Illustration G.15 shows the posting of the cash payments journal. Note that Karns uses the symbol **CP** as the posting reference. After postings are completed, the company proves the equality of the debit and credit balances in the general ledger. In addition, the control account balances should agree with the subsidiary ledger total balance. **Illustration G.16** shows the agreement of these balances.

ILLUSTRATION G.16 Proving the ledgers after postings from the sales, cash receipts, purchases, and cash payments journals

Effects of Special Journals on the General Journal

Special journals for sales, purchases, and cash substantially reduce the number of entries that companies make in the general journal. **Only transactions that cannot be entered in a special journal are recorded in the general journal.** For example, a company may use the general journal to record such transactions as granting of credit to a customer for a sales return or allowance, granting of credit from a supplier for purchases returned, acceptance of a note receivable from a customer, and purchase of equipment by issuing a note payable. Also, **correcting, adjusting, and closing entries are made in the general journal**.

The general journal has columns for date, account title and explanation, reference, and debit and credit amounts. When control and subsidiary accounts are not involved, the procedures for journalizing and posting of transactions are the same as those described in earlier chapters. When control and subsidiary accounts are involved, companies make two changes from the earlier procedures:

1. In **journalizing**, they identify both the control and the subsidiary accounts.
2. In **posting**, there must be a **dual posting**: once to the control account and once to the subsidiary account.

To illustrate, assume that on May 31, Karns Wholesale Supply returns $500 of merchandise for credit to Fabor and Son. **Illustration G.17** shows the entry in the general journal and the posting of the entry.

ILLUSTRATION G.17 Journalizing and posting the general journal

Note that the general journal indicates two accounts (Accounts Payable, and Fabor and Son) for the debit, and two postings (“201/✓”) in the reference column. One debit is posted to the control account and another debit is posted to the creditor’s account in the subsidiary ledger. If Karns receives cash instead of credit on this return, then it would record the transaction in the cash receipts journal.

Cybersecurity: A Final Comment

Have you ever been hacked? With the increasing use of cell phones, tablets, and social media, a real risk exists that your confidential information may be stolen and used illegally. Companies, individuals, and even nations have all been victims of **cybercrime**—a crime that involves the Internet, a computer system, or computer technology.

For companies, cybercrime is clearly a major threat as the hacking of employees' or customers' records can cost millions of dollars. Unfortunately, the number of security breaches is increasing. For example, shares of **SK Communications** (KOR) dropped 6% after the company reported that hackers stole the personal information of 35 million users of social network Cyworld (now Cyhome) and search engine Nate. Fortunately, since access was free, no financial data was taken.

Here are three reasons for the rise in the successful hacks of company computer records.

1. Companies and their employees continue to increase their activity on the Internet, primarily due to the use of mobile devices and cloud computing.
2. Companies today collect and store unprecedented amounts of personal data on customers and employees.
3. Companies often take measures to protect themselves from cybersecurity attacks but then fail to check if employees are carrying out the proper security guidelines.

Note that cybersecurity risks extend far beyond company operations and compliance. Many hackers target highly sensitive intellectual information or other strategic assets. **Illustration G.18** highlights the type of hackers and their motives, targets and impacts.

ILLUSTRATION G.18 Profiles of hackers

Malicious Actors	Motives	Targets	Impacts
Nation-state	• Economic, political, and/or military advantage	• Trade secrets • Sensitive business information • Emerging technologies • Critical infrastructure	• Loss of competitive advantage • Disruption to critical infrastructure
Organized crime	• Immediate financial gain • Collect information for future financial gains	• Financial/payment systems • Personally identifiable information • Payment card information • Protected health information	• Costly regulatory inquiries and penalties • Consumer and shareholder lawsuits • Loss of consumer confidence
Hacktivists	• Influence political and/or social change • Pressure businesses to change their practices	• Company secrets • Sensitive business information • Information related to key executives, employees, customers, and business partners	• Disruption of business activities • Harm to brand and reputation • Loss of consumer confidence
Insiders	• Personal advantage, monetary gain • Professional revenge • Patriotism	• Sales, deals, market strategies • Company secrets, intellectual property • Business operations • Personnel information	• Trade secret disclosure • Operational disruption • Harm to brand and reputation

Malicious Actors	Motives	Targets	Impacts
			• National security impact

Source: PriceWaterhouseCoopers, "Answering Your Cybersecurity Questions" (January 2014).

Companies now recognize that cybersecurity systems that protect confidential data must be implemented. It follows that companies (as well as nations and individuals) must continually verify that their cybersecurity defenses are sound and uncompromised.

Review

Learning Objectives Review

1 Describe the nature and purpose of a subsidiary ledger.

A subsidiary ledger is a group of accounts with a common characteristic. It facilitates the recording process by freeing the general ledger from details of individual balances.

2 Record transactions in special journals.

Companies use special journals to group similar types of transactions. In a special journal, generally only one line is used to record a complete transaction.

Glossary Review

Accounts payable (creditors') subsidiary ledger
A subsidiary ledger that collects transaction data of individual creditors.

Accounts receivable (customers') subsidiary ledger
A subsidiary ledger that collects transaction data of individual customers.

Cash payments (cash disbursements) journal
A special journal that records all disbursements of cash.

Cash receipts journal
A special journal that records all cash received.

Control account
An account in the general ledger that summarizes subsidiary ledger data.

Cybercrime
A crime that involves the Internet, a computer system, or computer technology.

Purchases journal
A special journal that records all purchases of merchandise on account.

Sales journal
A special journal that records all sales of merchandise on account.

Special journals
Journals that record similar types of transactions, such as all credit sales.

Subsidiary ledger
A group of accounts with a common characteristic.

Questions

1. What are the advantages of using subsidiary ledgers?

2. (a) When do companies normally post to (1) the subsidiary accounts and (2) the general ledger control accounts? (b) Describe the relationship between a control account and a subsidiary ledger.

3. Identify and explain the four special journals discussed in the appendix. List an advantage of using each of these journals rather than using only a general journal.

4. Kim Sports uses special journals. It recorded in a sales journal a sale made on account to R. Yang Co. for ¥435 (amounts in thousands). A few days later, Yang returns ¥70 worth of merchandise for credit. Where should Kim record the sales return? Why?

5. A €500 purchase of merchandise on account from Loire Gourmet Shops was properly recorded in the purchases journal. When posted, however, the amount recorded in the subsidiary ledger was €50. How might this error be discovered?

6. Why would special journals used in different businesses not be identical in format? What type of business would maintain a cash receipts journal but not include a column for accounts receivable?

7. The cash and the accounts receivable columns in the cash receipts journal were mistakenly over-added by €4,000 at the end of the month. (a) Will the accounts receivable ledger agree with the Accounts Receivable control account? (b) Assuming no other errors, will the trial balance totals be equal?

8. One column total of a special journal is posted at month-end to only two general ledger accounts. One of these two accounts is Accounts Receivable. What is the name of this special journal? What is the other general ledger account to which that same month-end total is posted?

9. In what journal would the following transactions be recorded? (Assume that a two-column sales journal and a single-column purchases journal are used.)

a. Recording of depreciation expense for the year.

b. Credit given to a customer for merchandise purchased on credit and returned.

c. Sales of merchandise for cash.

d. Sales of merchandise on account.

e. Collection of cash on account from a customer.

f. Purchase of office supplies on account.

10. In what journal would the following transactions be recorded? (Assume that a two-column sales journal and a single-column purchases journal are used.)

a. Cash received from signing a note payable.

b. Investment of cash by shareholders.

c. Closing of the expense accounts at the end of the year.

d. Purchase of merchandise on account.

e. Credit received for merchandise purchased and returned to supplier.

f. Payment of cash on account due a supplier.

11. What transactions might be included in a multiple-column purchases journal that would not be included in a single-column purchases journal?

12. Give an example of a transaction in the general journal that causes an entry to be posted twice (i.e., to two accounts), one in the general ledger, the other in the subsidiary ledger. Does this affect the debit/credit equality of the general ledger?

13. Give some examples of appropriate general journal transactions for an organization using special journals.

Brief Exercises

Identify subsidiary ledger balances.

BEG.1 (LO 1) Presented below is information related to Anping Manufacturing for its first month of operations. Identify the balances that appear in the accounts receivable subsidiary ledger and the accounts receivable balance that appears in the general ledger at the end of January.

Credit Sales			Cash Collections		
Jan. 7	Ling Ltd.	NT$10,000	Jan. 17	Ling Ltd.	NT$7,000
15	TMC Co.	8,000	24	TMC Co.	4,000
23	Wong Co.	9,000	29	Wong Co.	9,000

Identify subsidiary ledger accounts.

BEG.2 (LO 1) Identify in what ledger (general or subsidiary) each of the following accounts is shown.

a. Rent Expense.

b. Accounts Receivable—Cabrera.

c. Notes Payable.

d. Accounts Payable—Pacheco.

Identify special journals.

BEG.3 (LO 2) Identify the journal in which each of the following transactions is recorded.

a. Cash sales.

b. Payment of cash dividends.

c. Cash purchase of land.

d. Credit sales.

e. Purchase of merchandise on account.

f. Receipt of cash for services performed.

Identify entries to cash receipts journal.

BEG.4 (LO 2) Indicate whether each of the following debits and credits is included in the cash receipts journal. (Use "Yes" or "No" to answer this question.)

a. Debit to Sales Revenue.

b. Credit to Inventory.

c. Credit to Accounts Receivable.

d. Debit to Accounts Payable.

Identify transactions for special journals.

BEG.5 (LO 2) Hallasan Shoes uses special journals and a general journal. Identify the journal in which each of the following transactions is recorded.

a. Purchased equipment on account.

b. Purchased merchandise on account.

c. Paid utility expense in cash.

d. Sold merchandise on account.

Identify transactions for special journals.

BEG.6 (LO 2) Identify the special journal(s) in which the following column headings appear.

a. Sales Discounts Dr.

b. Accounts Receivable Cr.

c. Cash Dr.

d. Sales Revenue Cr.

e. Inventory Dr.

Indicate postings for cash receipts journal.

BEG.7 (LO 2) Papha Computer Components uses a multi-column cash receipts journal. Indicate which column(s) is/are posted only in total, only daily, or both in total and daily.

a. Accounts Receivable.

b. Sales Discounts.

c. Cash.

d. Other Accounts.

Exercises

Determine control account balances, and explain posting of special journals.

EG.1 (LO 1, 2) Semora Textiles uses both special journals and a general journal as described in this appendix. On June 30, after all monthly postings had been completed, the Accounts Receivable control account in the general ledger had a debit balance of ₩340,000; the Accounts Payable control account had a credit balance of ₩77,000 (amounts in thousands).

The July transactions recorded in the special journals are summarized below. No entries affecting accounts receivable and accounts payable were recorded in the general journal for July.

Sales journal	Total sales ₩161,400
Purchases journal	Total purchases ₩66,400
Cash receipts journal	Accounts receivable column total ₩131,000
Cash payments journal	Accounts payable column total ₩47,500

Instructions

a. What is the balance of the Accounts Receivable control account after the monthly postings on July 31?

b. What is the balance of the Accounts Payable control account after the monthly postings on July 31?

c. To what account(s) is the column total of ₩161,400 in the sales journal posted?

d. To what account(s) is the accounts receivable column total of ₩131,000 in the cash receipts journal posted?

Explain postings to subsidiary ledger.

EG.2 (LO 1) Presented below is the subsidiary accounts receivable account of Kam-Bo Hung.

Date	Ref.	Debit	Credit	Balance
2025				
Sept. 2	S31	61,000		61,000
9	G4		14,000	47,000
27	CR8		47,000	—

Instructions

Write an email to Lilly Cheung, chief financial officer, that explains each transaction.

Post various journals to control and subsidiary accounts.

EG.3 (LO 1, 2) On September 1, the balance of the Accounts Receivable control account in the general ledger of Zhao Foods was ¥10,960 (amounts in thousands). The customers' subsidiary ledger contained account balances as follows: Chang ¥1,440, Wu ¥2,640, Fung ¥2,060, and Tumen ¥4,820. At the end of September, the various journals contained the following information.

Sales journal: Sales to Tumen ¥800, to Chang ¥1,260, to Tamsui ¥1,330, and to Fung ¥1,600.

Cash receipts journal: Cash received from Fung ¥1,310, from Tumen ¥3,300, from Tamsui ¥380, from Wu ¥1,800, and from Chang ¥1,240.

General journal: An allowance is granted to Tumen ¥220.

Instructions

a. Set up control and subsidiary accounts and enter the beginning balances. Do not construct the journals.

b. Post the various journals. Post the items as individual items or as totals, whichever would be the appropriate procedure. (No sales discounts given.)

c. Prepare a schedule of accounts receivable and prove the agreement of the controlling account with the subsidiary ledger at September 30, 2025.

Determine control and subsidiary ledger balances for accounts receivable.

EG.4 (LO 1) Feng Decorators Company has a balance in its Accounts Receivable control account of ¥10,000 on January 1, 2025 (amounts in thousands). The subsidiary ledger contains three accounts: Long Company, balance ¥4,000; Chu Company, balance ¥2,500; and Fan Company. During January, the following receivable-related transactions occurred.

	Credit Sales	Collections	Returns
Long Company	¥9,000	¥8,000	¥ -0-
Chu Company	7,000	2,500	3,000
Fan Company	8,500	9,000	-0-

Instructions

a. What is the January 1 balance in the Fan Company subsidiary account?

b. What is the January 31 balance in the control account?

c. Compute the balances in the subsidiary accounts at the end of the month.

d. Which January transaction would not be recorded in a special journal?

Determine control and subsidiary ledger balances for accounts payable.

EG.5 (LO 1) Pennington SA has a balance in its Accounts Payable control account of €9,250 on January 1, 2025. The subsidiary ledger contains three accounts: Hale Co., balance €3,000; Janish Co., balance €1,875; and Valdez Co., balance unknown. During January, the following payable-related transactions occurred.

	Purchases	Payments	Returns
Hale Co.	€6,750	€6,000	€ -0-
Janish Co.	5,250	1,875	2,250
Valdez Co.	6,375	6,750	-0-

Instructions

a. What is the January 1 balance in the Valdez subsidiary account?

b. What is the January 31 balance in the control account?

c. Compute the balances in the subsidiary accounts at the end of the month.

d. Which January transaction would not be recorded in a special journal?

Record transactions in sales and purchases journal.

EG.6 (LO 2) Seo-hyeon's Auto Supply uses special journals and a general journal. The following transactions occurred during September 2025 (amounts in thousands).

Sept.	2	Sold merchandise on account to A. Jinwoo, invoice no. 101, NT$620, terms n/30. The cost of the merchandise sold was NT$420.
	10	Purchased merchandise on account from Jeju Company NT$650, terms 2/10, n/30.
	12	Purchased office equipment on account from C. Song NT$6,500.
	21	Sold merchandise on account to New Taiwan Supply Co., invoice no. 102 for NT$800, terms 2/10, n/30. The cost of the merchandise sold was NT$480.
	25	Purchased merchandise on account from Leung Sisters NT$860, terms n/30.
	27	Sold merchandise to Ulsan Company for NT$700 cash. The cost of the merchandise sold was NT$400.

Instructions

a. Prepare a sales journal (see Illustration G.6) and a single-column purchases journal (see Illustration G.12). (Use page 1 for each journal.)

b. Record the transaction(s) for September that should be journalized in the sales journal and the purchases journal.

Record transactions in cash receipts and cash payments journal.

EG.7 (LO 2) R. Lawrence Luggage uses special journals and a general journal. The following transactions occurred during May 2025.

May	1	R. Lawrence invested €40,000 cash in the business.
	2	Sold merchandise to Crapsky Co. for €6,300 cash. The cost of the merchandise sold was €4,200.
	3	Purchased merchandise for €7,700 from J. Mosca using check no. 101.
	14	Paid salary to K. Eyre €700 by issuing check no. 102.
	16	Sold merchandise on account to Stanton Company for €900, terms n/30. The cost of the merchandise sold was €630.
	22	A check of €9,000 is received from C. Galatoire in full for invoice 101; no discount given.

Instructions

a. Prepare a multiple-column cash receipts journal (see Illustration G.8) and a multiple-column cash payments journal (see Illustration G.15). (Use page 1 for each journal.)

b. Record the transaction(s) for May that should be journalized in the cash receipts journal and cash payments journal.

Explain journalizing in cash journals.

EG.8 (LO 2) Shou Computers uses the columnar cash journals illustrated in the text. In April, the following selected cash transactions occurred.

1. Made a refund to a customer as an allowance for damaged goods.
2. Received collection from customer within the 3% discount period.

3. Purchased merchandise for cash.
4. Paid a creditor within the 3% discount period.
5. Received collection from customer after the 3% discount period had expired.
6. Paid freight on merchandise purchased.
7. Paid cash for office equipment.
8. Received cash refund from supplier for merchandise returned.
9. Paid cash dividend to shareholders.
10. Made cash sales.

Instructions

Indicate (a) the journal, and (b) the columns in the journal that should be used in recording each transaction.

Journalize transactions in general journal and explain postings.

EG.9 (LO 2) Mama Liana Cakes has the following selected transactions during March (amounts in thousands).

Mar.	2	Purchased equipment costing Rp7,400 from Hasan Company on account.
	5	Received credit of Rp410 from Kusuma Company for merchandise damaged in shipment to Mama Liana.
	7	Issued credit of Rp400 to Bambang Company for merchandise the customer returned. The returned merchandise had a cost of Rp260.

Mama Liana uses a one-column purchases journal, a sales journal, the columnar cash journals used in the text, and a general journal.

Instructions

a. Journalize the transactions in the general journal.

b. In a brief email to the president of Mama Liana Cakes, explain the postings to the control and subsidiary accounts from each type of journal.

Indicate journalizing in special journals.

EG.10 (LO 2) Below are some typical transactions incurred by Cheung Publishers.

1. Payment of creditors on account.
2. Return of merchandise sold for credit.
3. Collection on account from customers.
4. Sale of land for cash.
5. Sale of merchandise on account.

6. Sale of merchandise for cash.
7. Received credit for merchandise purchased on credit.
8. Sales discount taken on goods sold.
9. Payment of employee wages.
10. Payment of cash dividend to shareholders.
11. Depreciation on building.
12. Purchase of office supplies for cash.
13. Purchase of merchandise on account.

Instructions

For each transaction, indicate whether it would normally be recorded in a cash receipts journal, cash payments journal, sales journal, single-column purchases journal, or general journal.

Explain posting to control account and subsidiary ledger.

EG.11 (LO 1, 2) The general ledger of Huang Marine Supply contained the following Accounts Payable control account (in T-account form). Also shown is the related subsidiary ledger (amounts in thousands of yen).

GENERAL LEDGER

Accounts Payable

Feb.	15	General journal	1,400	Feb.	1	Balance	26,025
	28	?	?		5	General journal	265
					11	General journal	550
					28	Purchases	13,400
				Feb.	28	Balance	10,500

ACCOUNTS PAYABLE LEDGER

Bak

Feb.	28	Bal.	4,600

Poon

Feb.	28	Bal.	?

Zhao

Feb.	28	Bal.	2,300

Instructions

a. Indicate the missing posting reference and amount in the control account, and the missing ending balance in the subsidiary ledger.

b. Indicate the amounts in the control account that were dual-posted (i.e., posted to the control account and the subsidiary accounts).

Prepare purchases and general journals.

EG.12 (LO 1, 2) Selected accounts from the ledgers of Youngblood Company at July 31 showed the following.

GENERAL LEDGER

Equipment No. 157

Date	Explanation	Ref.	Debit	Credit	Balance
July 1		G1	3,900		3,900

Accounts Payable No. 201

Date	Explanation	Ref.	Debit	Credit	Balance
July 1		G1		3,900	3,900
15		G1		400	4,300
18		G1	100		4,200
25		G1	200		4,000
31		P1		9,300	13,300

Inventory No. 120

Date	Explanation	Ref.	Debit	Credit	Balance
July 15		G1	400		400
18		G1		100	300
25		G1		200	100
31		P1	9,300		9,400

ACCOUNTS PAYABLE LEDGER

Bernardo Inc.

Date	Explanation	Ref.	Debit	Credit	Balance
July 15		G1		400	400

Flaherty Equipment Co.

Date	Explanation	Ref.	Debit	Credit	Balance
July 1		G1		3,900	3,900

Lange Corp.

Date	Explanation	Ref.	Debit	Credit	Balance
July 17		P1		1,400	1,400
18		G1	100		1,300
29		P1		1,600	2,900

Marsh Co.

Date	Explanation	Ref.	Debit	Credit	Balance
July 3		P1		2,400	2,400
20		P1		1,700	4,100

Weller Co.

Date	Explanation	Ref.	Debit	Credit	Balance
July 14		P1		1,100	1,100
25		G1	200		900

Yates Co.

Date	Explanation	Ref.	Debit	Credit	Balance
July 12		P1		500	500
21		P1		600	1,100

Instructions

From the data prepare:

a. The single-column purchases journal for July.

b. The general journal entries for July.

Determine correct posting amount to control account.

EG.13 (LO 1, 2) Zhao Products uses both special journals and a general journal as described in this appendix. Zhao also posts customers' accounts in the accounts receivable subsidiary ledger. The postings for the most recent month are included in the subsidiary T-accounts below (amounts in thousands of yen).

Baak

Bal.	–0–	145
	145	

Liang

Bal.	120	120
	190	
	150	

Faan

Bal.	150	150
	290	

So

Bal.	340	250
	200	

Instructions

Determine the correct amount of the end-of-month posting from the sales journal to the Accounts Receivable control account.

Compute balances in various accounts.

EG.14 (LO 2) Selected account balances for Hallasan Ltd. at January 1, 2025, are presented below (amounts in thousands).

Accounts Payable	₩14,000
Accounts Receivable	22,000
Cash	17,000
Inventory	13,500

Hallasan's sales journal for January shows a total of ₩110,000 in the selling-price column, and its one-column purchases journal for January shows a total of ₩77,000.

The column totals in Hallasan's cash receipts journal are Cash Dr. ₩61,000, Sales Discounts Dr. ₩1,100, Accounts Receivable Cr. ₩45,000, Sales Revenue Cr. ₩6,000, and Other Accounts Cr. ₩11,100.

The column totals in Hallasan's cash payments journal for January are Cash Cr. ₩55,000, Inventory Cr. ₩1,000, Accounts Payable Dr. ₩46,000, and Other Accounts Dr. ₩10,000. Hallasan's total cost of goods sold for January is ₩63,600.

Accounts Payable, Accounts Receivable, Cash, Inventory, and Sales Revenue are not involved in the Other Accounts column in either the cash receipts or cash payments journal, and are not involved in any general journal entries.

Instructions

Compute the January 31 balance for Hallasan in the following accounts.

a. Accounts Payable.

b. Accounts Receivable.

c. Cash.

d. Inventory.

e. Sales Revenue.

Problems

Journalize transactions in cash receipts journal; post to control account and subsidiary ledger.

PG.1 (LO 1, 2) Yansheng Market's chart of accounts includes the following selected accounts.

101	Cash	401	Sales Revenue
112	Accounts Receivable	414	Sales Discounts
120	Inventory	505	Cost of Goods Sold
311	Share Capital—Ordinary		

On April 1, the accounts receivable ledger of Yansheng Market showed the following balances (amounts in thousands): Lau HK$1,550, Gong HK$1,200, Chan Co. HK$2,900, and Chiu-Wai HK$2,200. The April transactions involving the receipt of cash were as follows.

Apr.	1	Shareholders invested additional cash in the business HK$7,200.
	4	Received check for payment of account from Chiu-Wai less 2% cash discount.
	5	Received check for HK$920 in payment of invoice no. 307 from Chan Co.
	8	Made cash sales of merchandise totaling HK$7,245. The cost of the merchandise sold was HK$4,347.
	10	Received check for HK$600 in payment of invoice no. 309 from Lau.
	11	Received cash refund from a supplier for damaged merchandise HK$740.
	23	Received check for HK$1,000 in payment of invoice no. 310 from Chan Co.
	29	Received check for payment of account from Gong (no cash discount allowed).

Instructions

a. Journalize the transactions above in a six-column cash receipts journal with columns for Cash Dr., Sales Discounts Dr., Accounts Receivable Cr., Sales Revenue Cr., Other Accounts Cr., and Cost of Goods Sold Dr./Inventory Cr. Foot and cross-foot the journal.

a. Balancing totals HK$25,452

b. Insert the beginning balances in the Accounts Receivable control and subsidiary accounts, and post the April transactions to these accounts.

c. Prove the agreement of the control account and subsidiary account balances.

c. Accounts Receivable HK$1,930

Journalize transactions in cash payments journal; post to control account and subsidiary ledgers.

PG.2 (LO 1, 2) Reineke Construction's chart of accounts includes the following selected accounts.

101	Cash	201	Accounts Payable
120	Inventory	332	Cash Dividends
130	Prepaid Insurance	505	Cost of Goods Sold
157	Equipment		

On October 1, the accounts payable ledger of Reineke Company showed the following balances: Uggla Company €2,700, Orr Co. €2,500, Rosenthal Co. €1,800, and Clevenger Company €3,700. The October transactions involving the payment of cash were as follows.

Oct.	1	Purchased merchandise, check no. 63, €300.
	3	Purchased equipment, check no. 64, €800.
	5	Paid Uggla Company balance due of €2,700, less 2% discount, check no. 65, €2,646.
	10	Purchased merchandise, check no. 66, €2,550.
	15	Paid Rosenthal Co. balance due of €1,800, check no. 67.
	16	Paid cash dividend of €400, check no. 68.
	19	Paid Orr Co. in full for invoice no. 610, €2,000 less 2% cash discount, check no. 69, €1,960.
	29	Paid Clevenger Company in full for invoice no. 264, €2,500, check no. 70.

Instructions

a. Journalize the transactions above in a four-column cash payments journal with columns for Other Accounts Dr., Accounts Payable Dr., Inventory Cr., and Cash Cr. Foot and cross-foot the journal.

a. Balancing totals €13,050

b. Insert the beginning balances in the Accounts Payable control and subsidiary accounts, and post the October transactions to these accounts.

c. Prove the agreement of the control account and the subsidiary account balances.

c. Accounts Payable €1,700

Journalize transactions in multi-column purchases journal and sales journal; post to the general and subsidiary ledgers.

PG.3 (LO 1, 2) The chart of accounts of LR Scooters includes the following selected accounts.

112	Accounts Receivable	401	Sales Revenue
120	Inventory	412	Sales Returns and Allowances
126	Supplies	505	Cost of Goods Sold
157	Equipment	610	Advertising Expense
201	Accounts Payable		

In July, the following transactions were completed (amounts in thousands). All purchases and sales were on account. The cost of all merchandise sold was 70% of the sales price.

July	1	Purchased merchandise from Oong Company NT$8,000.
	2	Received freight bill from Laau Shipping on Oong purchase NT$400.
	3	Made sales to Choi Company NT$1,300 and to Huang Bros. NT$1,500.
	5	Purchased merchandise from Goo Company NT$3,200.
	8	Received credit on merchandise returned to Goo Company NT$300.
	13	Purchased store supplies from Ngg Supply NT$720.
	15	Purchased merchandise from Oong Company NT$3,600 and from Soxng Company NT$4,300.
	16	Made sales to Aang Company NT$3,450 and to Huang Bros. NT$1,870.
	18	Received bill for advertising from Viun Advertisements NT$600.
	21	Sales were made to Choi Company $310 and to Zafn Company NT$2,800.
	22	Granted allowance to Choi Company for merchandise damaged in shipment NT$40.
	24	Purchased merchandise from Goo Company NT$3,000.
	26	Purchased equipment from Ngg Supply NT$900.
	28	Received freight bill from Laau Shipping on Goo purchase of July 24, NT$380.
	30	Sales were made to Aang Company NT$5,600.

Instructions

a. Journalize the transactions above in a purchases journal, a sales journal, and a general journal. The purchases journal should have the following column headings: Date, Account Credited (Debited), Ref., Accounts Payable Cr., Inventory Dr., and Other Accounts Dr.

a. Purchases journal—
Accounts Payable NT$25,100
Sales journal—Sales
Revenue NT$16,830

b. Post to both the general and subsidiary ledger accounts. (Assume that all accounts have zero beginning balances.)

c. Prove the agreement of the control and subsidiary accounts.

c. Accounts Receivable
NT$16,790
Accounts Payable NT$24,800

Journalize transactions in special journals.

PG.4 (LO 1, 2) Selected accounts from the chart of accounts of Meng Enterprises are shown below.

101	Cash	401	Sales Revenue
112	Accounts Receivable	412	Sales Returns and Allowances
120	Inventory	414	Sales Discounts
126	Supplies	505	Cost of Goods Sold
157	Equipment	726	Salaries and Wages Expense
201	Accounts Payable		

The cost of all merchandise sold was 60% of the sales price. During January, Meng completed the following transactions (amounts in thousands).

Jan.	3	Purchased merchandise on account from Gum Co. ¥9,000.
	4	Purchased supplies for cash ¥80.
	4	Sold merchandise on account to Wei ¥5,250, invoice no. 371, terms 1/10, n/30.
	5	Returned ¥300 worth of damaged goods purchased on account from Gum Co. on January 3.
	6	Made cash sales for the week totaling ¥3,150.
	8	Purchased merchandise on account from Pang Co. ¥4,500.
	9	Sold merchandise on account to Loeng Corp. ¥5,400, invoice no. 372, terms 1/10, n/30.
	11	Purchased merchandise on account from Che Co. ¥3,700.
	13	Paid in full Gum Co. on account less a 2% discount.
	13	Made cash sales for the week totaling ¥6,260.
	15	Received payment from Loeng Corp. for invoice no. 372.
	15	Paid semi-monthly salaries of ¥14,300 to employees.
	17	Received payment from Wei for invoice no. 371.
	17	Sold merchandise on account to Dyun Co. ¥1,200, invoice no. 373, terms 1/10, n/30.
	19	Purchased equipment on account from Ziu Corp. ¥5,500.
	20	Cash sales for the week totaled ¥3,200.
	20	Paid in full Pang Co. on account less a 2% discount.
	23	Purchased merchandise on account from Gum Co. ¥7,800.
	24	Purchased merchandise on account from Yap Corp. ¥5,100.
	27	Made cash sales for the week totaling ¥4,230.
	30	Received payment from Dyun Co. for invoice no. 373.
	31	Paid semi-monthly salaries of ¥13,200 to employees.
	31	Sold merchandise on account to Wei ¥9,330, invoice no. 374, terms 1/10, n/30.

Meng uses the following journals.

1. Sales journal.
2. Single-column purchases journal.
3. Cash receipts journal with columns for Cash Dr., Sales Discounts Dr., Accounts Receivable Cr., Sales Revenue Cr., Other Accounts Cr., and Cost of Goods Sold Dr./Inventory Cr.

4. Cash payments journal with columns for Other Accounts Dr., Accounts Payable Dr., Inventory Cr., and Cash Cr.
5. General journal.

Instructions

Using the selected accounts provided:

a. Record the January transactions in the appropriate journal noted.

a. Sales journal ¥21,180
Purchases journal ¥30,100
Cash receipts journal balancing total ¥38,794
Cash payments journal balancing total ¥40,780

b. Foot and cross-foot all special journals.

c. Show how postings would be made by placing ledger account numbers and checkmarks as needed in the journals. (Actual posting to ledger accounts is not required.)

Journalize in sales and cash receipts journals; post; prepare a trial balance; prove control to subsidiary; prepare adjusting entries; prepare an adjusted trial balance.

PG.5 (LO 1, 2) Presented below are the purchases and cash payments journals for Adhikari Group for its first month of operations (amounts in thousands).

PURCHASES JOURNAL **P1**

Date	Account Credited	Ref.	Inventory Dr. Accounts Payable Cr.
July 4	N. Akhand		6,800
5	Pai Co.		8,100
11	J. Gupta		5,920
13	Huq Co.		15,300
20	M. Maji		7,900
			44,020

CASH PAYMENTS JOURNAL **CP1**

Date	Account Debited	Ref.	Other Accounts Dr.	Accounts Payable Dr.	Inventory Cr.	Cash Cr.
July 4	Supplies		600			600
10	Pai Co.			8,100	81	8,019
11	Prepaid Rent		6,000			6,000
15	N. Akhand			6,800		6,800
19	Cash Dividends		2,500			2,500
21	Huq Co.			15,300	153	15,147
			9,100	30,200	234	39,066

In addition, the following transactions have not been journalized for July. The cost of all merchandise sold was 65% of the sales price.

July 1 The founder, A. Adhikari, invests ₹80,000 in cash.
6 Sell merchandise on account to Chatterjee Co. $6,200 terms 1/10, n/30.
7 Make cash sales totaling ₹8,000.
8 Sell merchandise on account to S. Garga ₹4,600, terms 1/10, n/30.
10 Sell merchandise on account to Kutsa Co. ₹4,900, terms 1/10, n/30.
13 Receive payment in full from S. Garga.
16 Receive payment in full from Kutsa Co.
20 Receive payment in full from Chatterjee Co.
21 Sell merchandise on account to R. Kumar ₹5,000, terms 1/10, n/30.
29 Returned damaged goods to N. Akhand and received cash refund of ₹420.

Instructions

a. Open the following accounts in the general ledger.

101	Cash	332	Cash Dividends
112	Accounts Receivable	401	Sales Revenue
120	Inventory	414	Sales Discounts

126	Supplies	505	Cost of Goods Sold
131	Prepaid Rent	631	Supplies Expense
201	Accounts Payable	729	Rent Expense
311	Share Capital—Ordinary		

b. Journalize the transactions that have not been journalized in the sales journal and the cash receipts journal (see Illustration G.8).

b. Sales journal total ₹20,700
Cash receipts journal
balancing total ₹109,320

c. Post to the accounts receivable and accounts payable subsidiary ledgers. Follow the sequence of transactions as shown in the problem.

d. Post the individual entries and totals to the general ledger.

e. Prepare a trial balance at July 31, 2025.

e. Totals ₹122,520

f. Determine whether the subsidiary ledgers agree with the control accounts in the general ledger.

f. Accounts Receivable ₹5,000
Accounts Payable ₹13,820

g. The following adjustments at the end of July are necessary.

1. A count of supplies indicates that ₹140 is still on hand.
2. Recognize rent expense for July, ₹500.

Prepare the necessary entries in the general journal. Post the entries to the general ledger.

h. Prepare an adjusted trial balance at July 31, 2025.

h. Totals ₹122,520

Journalize in special journals; post; prepare a trial balance.

PG.6 (LO 1, 2) The post-closing trial balance for Horner Autos is shown below.

Horner Autos
Post-Closing Trial Balance
December 31, 2024

	Debit	Credit
Cash	€ 41,500	
Accounts Receivable	15,000	
Notes Receivable	45,000	
Inventory	23,000	
Equipment	6,450	
Accumulated Depreciation—Equipment		€ 1,500
Accounts Payable		43,000
Share Capital—Ordinary		60,000
Retained Earnings		26,450
	€130,950	€130,950

The subsidiary ledgers contain the following information: (1) accounts receivable—B. Hannigan €2,500, I. Kirk €7,500, and T. Hodges €5,000; (2) accounts payable—T. Igawa €12,000, D. Danford €18,000, and K. Thayer €13,000. The cost of all merchandise sold was 60% of the sales price.

The transactions for January 2025 are as follows.

Jan.	3	Sell merchandise to M. Ziesmer €8,000, terms 2/10, n/30.
	5	Purchase merchandise from E. Pheatt €2,000, terms 2/10, n/30.
	7	Receive a check from T. Hodges €3,500.
	11	Pay freight on merchandise purchased €300.
	12	Pay rent of €1,000 for January.
	13	Receive payment in full from M. Ziesmer.
	14	Post all entries to the subsidiary ledgers. Issued credit of €300 to B. Hannigan for returned merchandise.
	15	Send K. Thayer a check for €12,870 in full payment of account, discount €130.
	17	Purchase merchandise from G. Roland €1,600, terms 2/10, n/30.
	18	Pay sales salaries of €2,800 and office salaries €2,000.
	20	Give D. Danford a 60-day note for €18,000 in full payment of account payable.
	23	Total cash sales amount to €9,100.
	24	Post all entries to the subsidiary ledgers. Sell merchandise on account to I. Kirk €7,400, terms 1/10, n/30.
	27	Send E. Pheatt a check for €950.
	29	Receive payment on a note of €40,000 from B. Stout.
	30	Post all entries to the subsidiary ledgers. Return merchandise of €300 to G. Roland for credit.

Instructions

a. Open general and subsidiary ledger accounts for the following.

101	Cash	311	Share Capital—Ordinary
112	Accounts Receivable	401	Sales Revenue
115	Notes Receivable	412	Sales Returns and Allowances
120	Inventory	414	Sales Discounts
157	Equipment	505	Cost of Goods Sold
158	Accumulated Depreciation—Equipment	726	Salaries and Wages Expense
200	Notes Payable	729	Rent Expense
201	Accounts Payable		

b. Record the January transactions in a sales journal, a single-column purchases journal, a cash receipts journal (see Illustration G.8), a cash payments journal (see Illustration G.15), and a general journal.

b. Sales journal €15,400
Purchases journal €3,600
Cash receipts journal
(balancing) €66,060
Cash payments journal
(balancing) €20,050

c. Post the appropriate amounts to the general ledger.

d. Prepare a trial balance at January 31, 2025.

d. Totals €144,800

e. Determine whether the subsidiary ledgers agree with controlling accounts in the general ledger.

e. Accounts Receivable €18,600
Accounts Payable €14,350

Comprehensive Accounting Cycle Review

ACRG.1 (Perpetual Method) Koto Merchants uses a perpetual inventory system and both an accounts receivable and an accounts payable subsidiary ledger. Balances related to both the general ledger and the subsidiary ledgers for Koto are indicated (amounts in thousands). Also following are a series of transactions for Koto for the month of January. Credit sales terms are 2/10, n/30. The cost of all merchandise sold was 60% of the sales price.

GENERAL LEDGER

Account Number	Account Title	January 1 Opening Balance
101	Cash	Rp35,750
112	Accounts Receivable	13,000
115	Notes Receivable	39,000
120	Inventory	18,000
126	Supplies	1,000
130	Prepaid Insurance	2,000
157	Equipment	6,450
158	Accumulated Depreciation—Equip.	1,500
201	Accounts Payable	35,000

311	Share Capital—Ordinary	50,000
320	Retained Earnings	28,700

Schedule of Accounts Receivable
(from accounts receivable subsidiary ledger)

Customer	January 1 Opening Balance
Bodi Co.	Rp1,500
Mohede Co.	4,000
Sueba Co.	7,500

Schedule of Accounts Payable
(from accounts payable subsidiary ledger)

Creditor	January 1 Opening Balance
R. Manuwa	Rp15,000
Medan Co.	9,000
Shihab Co.	11,000

Jan.	3	Sell merchandise on account to B. Chen Rp3,600, invoice no. 510, and to Tjong Company Rp1,800, invoice no. 511.
	5	Purchase merchandise from Goh Co. Rp5,000 and D. Phe Rp2,200, terms n/30.
	7	Receive checks from Mohede Rp4,000 and Sueba Rp2,000 after discount period has lapsed.
	8	Pay freight on merchandise purchased Rp235.
	9	Send checks to Medan for Rp9,000 less 2% cash discount, and to Shihab for Rp11,000 less 1% cash discount.
	9	Issue credit of Rp300 to Tjong for merchandise returned.
	10	Daily cash sales from January 1 to January 10 total Rp15,500. Make one journal entry for these sales.
	11	Sell merchandise on account to Bodi Rp1,600, invoice no. 512, and to Mohede Rp900, invoice no. 513.
	12	Pay rent of Rp1,000 for January.
	13	Receive payment in full from B. Chen and Tjong less cash discounts.
	15	Paid dividend of Rp800 cash.
	15	Post all entries to the subsidiary ledgers.
	16	Purchase merchandise from Shihab Rp15,000, terms 1/10, n/30; Medan Rp14,200, terms 2/10, n/30; and Goh Rp1,500, terms n/30.
	17	Pay Rp400 cash for office supplies.
	18	Return Rp200 of merchandise to Medan and receive credit.
	20	Daily cash sales from January 11 to January 20 total Rp20,100. Make one journal entry for these sales.
	21	Issue Rp15,000 note, maturing in 90 days, to R. Manuwa in payment of balance due.
	21	Receive payment in full from Mohede less cash discount.
	22	Sell merchandise on account to B. Chen Rp2,700, invoice no. 514, and to Bodi Rp2,300, invoice no. 515.
	22	Post all entries to the subsidiary ledgers.
	23	Send checks to Shihab and Medan for full payment less cash discounts.
	25	Sell merchandise on account to Sueba Rp3,500, invoice no. 516, and to Tjong Rp6,100, invoice no. 517.
	27	Purchase merchandise from Shihab Rp14,500, terms 1/10, n/30; D. Phe Rp3,200, terms n/30; and Goh Rp5,400, terms n/30.
	27	Post all entries to the subsidiary ledgers.
	28	Pay Rp200 cash for office supplies.
	31	Daily cash sales from January 21 to January 31 total Rp21,300. Make one journal entry for these sales.
	31	Pay sales salaries Rp4,300 and office salaries Rp3,800.

Instructions

a. Record the January transactions in a sales journal, a single-column purchases journal, a cash receipts journal as shown in Illustration G.8, a cash payments journal as shown in Illustration G.15, and a two-column general journal.

b. Post the journals to the general ledger.

c. Prepare a trial balance at January 31, 2025, in the trial balance columns of the worksheet. Complete the worksheet using the following additional information.

    1. Office supplies at January 31 total Rp900.
    2. Insurance coverage expires on October 31, 2025.
    3. Annual depreciation on the equipment is Rp1,500.
    4. Interest of Rp50 has accrued on the note payable.

d. Prepare an income statement and a retained earnings statement for January and a classified statement of financial position at January 31, 2025.

e. Prepare and post adjusting and closing entries.

f. Prepare a post-closing trial balance for January 31, 2025, and determine whether the subsidiary ledgers agree with the control accounts in the general ledger.

ACRG.2 (Periodic Inventory) Yi Ltd. has the following opening account balances in its general and subsidiary ledgers on January 1 and uses the periodic inventory system. All accounts have normal debit and credit balances (amounts in thousands).

GENERAL LEDGER

Account Number	Account Title	January 1 Opening Balance
101	Cash	₩33,750
112	Accounts Receivable	13,000
115	Notes Receivable	39,000
120	Inventory	20,000
126	Supplies	1,000
130	Prepaid Insurance	2,000
157	Equipment	6,450
158	Accumulated Depreciation—Equip.	1,500
201	Accounts Payable	35,000
311	Share Capital—Ordinary	60,000
320	Retained Earnings	18,700

Schedule of Accounts Receivable
(from accounts receivable subsidiary ledger)

Customer	January 1 Opening Balance
Au & Sons	₩4,000
B. Bak	7,500
R. Kang	1,500

Schedule of Accounts Payable
(from accounts payable subsidiary ledger)

Creditor	January 1 Opening Balance
Bai Co.	₩11,000
Oe Sisters	9,000
R. Ryu	15,000

In addition, the following transactions have not been journalized for January 2025.

Jan.	3	Sell merchandise on account to Baozi Co. ₩3,600, invoice no. 510, and Lim Co. ₩1,800, invoice no. 511.
	5	Purchase merchandise on account from S. Chen ₩5,000 and Koh Co. ₩2,700.
	7	Receive checks for ₩4,000 from Au & Sons and ₩2,000 from B. Bak.
	8	Pay freight on merchandise purchased ₩180.
	9	Send checks to Oe Sisters for ₩9,000 and Bai Co. for ₩11,000.
	9	Issue credit of ₩300 to Lim Co. for merchandise returned.
	10	Cash sales from January 1 to January 10 total ₩15,500. Make one journal entry for these sales.
	11	Sell merchandise on account to R. Kang for ₩2,900, invoice no. 512, and to Au & Sons ₩900, invoice no. 513. Post all entries to the subsidiary ledgers.
	12	Pay rent of ₩1,000 for January.
	13	Receive payment in full from Baozi Co. and Lim Co.
	15	Pay ₩800 cash dividends.
	16	Purchase merchandise on account from Bai Co. for ₩12,000, from Oe Sisters for ₩13,900, and from S. Chen for ₩1,500.
	17	Pay ₩400 cash for supplies.
	18	Return ₩200 of merchandise to Oe Sisters and receive credit.
	20	Cash sales from January 11 to January 20 total ₩17,500. Make one journal entry for these sales.
	21	Issue ₩15,000 note to R. Ryu in payment of balance due.
	21	Receive payment in full from Au & Sons. Post all entries to the subsidiary ledgers.
	22	Sell merchandise on account to Baozi Co. for ₩3,700, invoice no. 514, and to R. Kang for ₩800, invoice no. 515.
	23	Send checks to Bai Co. and Oe Sisters in full payment.
	25	Sell merchandise on account to B. Bak for ₩3,500, invoice no. 516, and to Lim Co. for ₩6,100, invoice no. 517.
	27	Purchase merchandise on account from Bai Co. for ₩12,500, from Koh Co. for ₩1,200, and from S. Chen for ₩2,800.
	28	Pay ₩200 cash for office supplies.
	31	Cash sales from January 21 to January 31 total ₩22,920. Make one journal entry for these sales.
	31	Pay sales salaries of ₩4,300 and office salaries of ₩3,600.

Instructions

a. Record the January transactions in the appropriate journal—sales, purchases, cash receipts, cash payments, and general.

b. Post the journals to the general and subsidiary ledgers. Add and number new accounts in an orderly fashion as needed.

c. Prepare a trial balance at January 31, 2025, using a worksheet. Complete the worksheet using the following additional information.

   1. Supplies at January 31 total ₩700.
   2. Insurance coverage expires on October 31, 2025.
   3. Annual depreciation on the equipment is ₩1,500.
   4. Interest of ₩30 has accrued on the note payable.
   5. Inventory at January 31 is ₩15,000.

d. Prepare an income statement and a retained earnings statement for January 2025 and a classified statement of financial position at January 31, 2025.

e. Prepare and post the adjusting and closing entries.

f. Prepare a post-closing trial balance for January 31, 2025, and determine whether the subsidiary ledgers agree with the control accounts in the general ledger.

Account Classification and Presentation			
Account Title	Classification	Financial Statement	Normal Balance
A			
Accounts Payable	Current Liability	Statement of Financial Position	Credit
Accounts Receivable	Current Asset	Statement of Financial Position	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Statement of Financial Position	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Statement of Financial Position	Credit
Administrative Expenses	Operating Expense	Income Statement	Debit
Advertising Expense	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Statement of Financial Position	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
B			
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Non-Current Liability	Statement of Financial Position	Credit
Buildings	Plant Asset	Statement of Financial Position	Debit
C			
Cash	Current Asset	Statement of Financial Position	Debit
Copyrights	Intangible Asset	Statement of Financial Position	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
D			
Debt Investments	Current Asset/Long-Term Investment	Statement of Financial Position	Debit

Account Classification and Presentation			
Account Title	Classification	Financial Statement	Normal Balance
Depreciation Expense	Operating Expense	Income Statement	Debit
Dividend Revenue	Other Income and Expense	Income Statement	Credit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Statement of Financial Position	Credit
E			
Equipment	Plant Asset	Statement of Financial Position	Debit
F			
Freight-Out	Operating Expense	Income Statement	Debit
G			
Gain on Disposal of Plant Assets	Other Income and Expense	Income Statement	Credit
Goodwill	Intangible Asset	Statement of Financial Position	Debit
I			
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Statement of Financial Position	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Income and Expense	Income Statement	Debit
Interest Payable	Current Liability	Statement of Financial Position	Credit
Interest Receivable	Current Asset	Statement of Financial Position	Debit
Interest Revenue	Other Income and Expense	Income Statement	Credit

Account Classification and Presentation			
Account Title	Classification	Financial Statement	Normal Balance
Inventory	Current Asset	Statement of Financial Position (2)	Debit
L			
Land	Plant Asset	Statement of Financial Position	Debit
Loss on Disposal of Plant Assets	Other Income and Expense	Income Statement	Debit
M			
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Non-Current Liability	Statement of Financial Position	Credit
N			
Notes Payable	Current Liability/Non-Current Liability	Statement of Financial Position	Credit
P			
Patents	Intangible Asset	Statement of Financial Position	Debit
Prepaid Insurance	Current Asset	Statement of Financial Position	Debit
R			
Rent Expense	Operating Expense	Income Statement	Debit
Research and Development Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Equity	Statement of Financial Position and Retained Earnings Statement	Credit
S			
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Statement of Financial Position	Credit

Account Classification and Presentation			
Account Title	**Classification**	**Financial Statement**	**Normal Balance**
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Share Capital—Ordinary	Equity	Statement of Financial Position	Credit
Share Capital—Preference	Equity	Statement of Financial Position	Credit
Share Investments	Current Asset/Long-Term Investment	Statement of Financial Position	Debit
Share Premium—Ordinary	Equity	Statement of Financial Position	Credit
Share Premium—Preference	Equity	Statement of Financial Position	Credit
Supplies	Current Asset	Statement of Financial Position	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
T			
Treasury Shares	Equity—Contra	Statement of Financial Position	Debit
U			
Unearned Service Revenue	Current Liability	Statement of Financial Position	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

(1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.

(2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.

The following is a sample chart of accounts. It does not represent a comprehensive chart of all the accounts used in this text but rather those accounts that are commonly used. This sample chart of accounts is for a company that generates both service revenue as well as sales revenue. It uses the perpetual approach to inventory. If a periodic system was used, the following temporary accounts would be needed to record inventory purchases: Purchases, Freight-In, Purchase Returns and Allowances, and Purchase Discounts.

Chart of Accounts				
Assets	**Liabilities**	**Equity**	**Revenues**	**Expenses**
Cash	Notes Payable	Share Capital—Preference	Service Revenue	Administrative Expenses
Accounts Receivable	Accounts Payable	Share Capital—Ordinary	Sales Revenue	Amortization Expense
Allowance for Doubtful Accounts	Unearned Service Revenue	Share Premium—Preference	Sales Discounts	Bad Debt Expense
Interest Receivable	Salaries and Wages Payable	Share Premium—Ordinary	Sales Returns and Allowances	Cost of Goods Sold
Inventory	Interest Payable	Retained Earnings	Interest Revenue	Depreciation Expense
Supplies	Dividends Payable	Treasury Shares	Gain on Disposal of Plant Assets	Freight-Out
Prepaid Insurance	Income Taxes Payable	Dividends		Income Tax Expense
Land	Bonds Payable	Income Summary		Insurance Expense
Equipment	Mortgage Payable			Interest Expense
Accumulated Depreciation—Equipment				Loss on Disposal of Plant Assets
Buildings				Maintenance and Repairs Expense
Accumulated Depreciation—Buildings				Rent Expense
Copyrights				Salaries and Wages Expense
Goodwill				Selling Expenses
Patents				Supplies Expense
				Utilities Expense