CHAPTER 3

The Accounting Information System

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics		Questions	Brief Exercises	Exercises	Problems
1.	Transaction identification.	1, 2, 3, 5	1, 2	1, 2, 3, 4, 17	1
2.	Nominal accounts.	4, 7			
3.	Trial balance.	6, 10		2, 3, 4	1, 2, 7
4.	Adjusting entries.	8, 11, 13, 14	3, 4, 5, 6, 7, 8, 9, 10	5, 6, 7, 8, 9, 10, 20	1, 2, 3, 4, 5, 6, 7, 8, 9, 11
5.	Financial statements.			11, 12, 15, 22, 23	1, 2, 4, 6
6.	Closing.	12	11	13, 14, 16	1, 4, 8, 9, 11
7.	Inventory and cost of goods sold.	9		12, 14, 15	
8.	Comprehensive accounting cycle.				1, 2, 6, 11
*9.	International convergence.	15, 16, 17			
*10.	Cash vs. Accrual Basis.	18, 19, 20	12	18, 19	10
*11.	Reversing entries.	21	13	20	
*12.	Worksheet.	22		21, 22, 23	11

*These topics are dealt with in an Appendix to the Chapter.

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Problems
1. Understand basic accounting terminology.			
2. Explain double-entry rules.			
3. Identify steps in accounting cycle.			
4. Record transactions in journals, post to ledger accounts, and prepare a trial balance.	1, 2, 3, 4, 5, 6, 7	1, 2, 3, 4, 17	1, 4, 8, 9
5. Explain the reasons for preparing adjusting entries.	3, 4, 5, 6, 7, 8, 9, 10	5, 6, 7, 8, 9, 10, 20	2, 3, 4, 5, 6, 7, 8, 9, 11
6. Prepare financial statements from the adjusted trail balance.		11, 12, 15	1, 2, 4, 6, 7, 8, 9, 11
7. Prepare closing entries.	11	13, 14, 16	1, 4, 8, 9, 11
*8. Differentiate the cash basis of accounting from the accrual basis of accounting.	12	18, 19	10
*9. Identify adjusting entries that may be reversed.	13	20	
*10. Prepare a 10-column worksheet.		21, 22, 23	11

*These topics are dealt with in an Appendix to the Chapter.

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E3-1	Transaction analysis–service company.	Simple	15–20
E3-2	Corrected trial balance.	Simple	10–15
E3-3	Corrected trial balance.	Simple	15–20
E3-4	Corrected trial balance.	Simple	10–15
E3-5	Adjusting entries.	Moderate	10–15
E3-6	Adjusting entries.	Moderate	15–20
E3-7	Analyze adjusted data.	Complex	15–20
E3-8	Adjusting entries.	Moderate	10–15
E3-9	Adjusting entries.	Moderate	15–20
E3-10	Adjusting entries.	Complex	25–30
E3-11	Prepare financial statements.	Moderate	20–25
E3-12	Prepare financial statements.	Moderate	20–25
E3-13	Closing entries.	Simple	10–15
E3-14	Closing entries.	Moderate	10–15
E3-15	Missing amounts.	Simple	10–15
E3-16	Closing entries for a corporation.	Moderate	10–15
E3-17	Transactions of a corporation, including investment and dividend.	Moderate	10–15
*E3-18	Cash to accrual basis.	Moderate	15–20
*E3-19	Cash to accrual basis.	Moderate	10–15
*E3-20	Adjusting and reversing entries.	Complex	20–25
*E3-21	Worksheet.	Simple	10–15
*E3-22	Worksheet and statement of financial position presentation.	Moderate	20–25
*E3-23	Partial worksheet preparation.	Moderate	10–15
P3-1	Transactions, financial statements–service company.	Moderate	25–35
P3-2	Adjusting entries and financial statements.	Moderate	35–40
P3-3	Adjusting entries.	Moderate	25–30
P3-4	Financial statements, adjusting and closing entries.	Moderate	40–50
P3-5	Adjusting entries.	Moderate	15–20
P3-6	Adjusting entries and financial statements.	Moderate	25–35
P3-7	Adjusting entries and financial statements.	Moderate	25–35
P3-8	Adjusting and closing.	Moderate	30–40
P3-9	Adjusting and closing.	Moderate	30–35
*P3-10	Cash and accrual basis.	Moderate	35–40
*P3-11	Worksheet, statement of financial position, adjusting and closing entries.	Complex	40–50

ANSWERS TO QUESTIONS

1. Examples are:
(a) Payment of an accounts payable.
(b) Collection of an accounts receivable from a customer.
(c) Transfer of an accounts payable to a note payable.

2. Transactions (a), (b), (d) are considered business transactions and are recorded in the accounting records because a change in assets, liabilities, or equity has been effected as a result of a transfer of values from one party to another. Transactions (c) and (e) are not business transactions because a transfer of values has not resulted, nor can the event be considered financial in nature and capable of being expressed in terms of money.

3. Transaction (a): Accounts Receivable (debit), Service Revenue (credit).
Transaction (b): Cash (debit), Accounts Receivable (credit).
Transaction (c): Office Supplies (debit), Accounts Payable (credit).
Transaction (d): Delivery Expense (debit), Cash (credit).

4. Revenue and expense accounts are referred to as temporary or nominal accounts because each period they are closed out to Income Summary in the closing process. Their balances are reduced to zero at the end of the accounting period; therefore, the term temporary or nominal is given to these accounts.

5. Andrea is not correct. The double-entry system means that for every debit amount there must be a credit amount and vice-versa. At least two accounts are affected. It does not mean that each transaction must be recorded twice.

6. Although it is not absolutely necessary that a trial balance be taken periodically, it is customary and desirable. The trial balance accomplishes two principal purposes:
(1) It tests the accuracy of the entries in that it proves that debits and credits of an equal amount are in the ledger.
(2) It provides a list of ledger accounts and their balances which may be used in preparing the financial statements and in supplying financial data about the concern.

7. (a) Real account; statement of financial position.
(b) Real account; statement of financial position.
(c) Merchandise inventory is generally considered a real account appearing on the statement of financial position. It has the elements of a nominal account when the periodic inventory system is used. It may appear on the income statement when the multiple-step format is used under a periodic inventory system.
(d) Real account; statement of financial position.
(e) Real account; statement of financial position.
(f) Nominal account; income statement.
(g) Nominal account; income statement.
(h) Real account; statement of financial position.

8. At December 31, the three days' wages due to the employees represent a current liability. The related expense must be recorded in this period to properly reflect the expense incurred.

9. (a) In a service company, revenues are service revenues and expenses are operating expenses. In a merchandising company, revenues are sales revenues and expenses consist of cost of goods sold plus operating expenses.
(b) The measurement process in a merchandising company consists of comparing the sales price of the merchandise inventory to the cost of goods sold and operating expenses.

10. (a) No change.
(b) Before closing, balances exist in these accounts; after closing, no balances exist.
(c) Before closing, balances exist in these accounts; after closing, no balances exist.
(d) Before closing, a balance exists in this account exclusive of any dividends or the net income or net loss for the period; after closing, the balance is increased or decreased by the amount of net income or net loss, and decreased by dividends declared.
(e) No change.

11. Adjusting entries are prepared prior to the preparation of financial statements in order to bring the accounts up to date and are necessary (1) to achieve a proper matching of revenues and expenses in measuring income and (2) to achieve an accurate presentation of assets, liabilities and equity.

12. Closing entries are prepared to transfer the balances of nominal accounts to capital (retained earnings) after the adjusting entries have been recorded and the financial statements prepared. Closing entries are necessary to reduce the balances in nominal accounts to zero in order to prepare the accounts for the next period's transactions.

13. Cost – Salvage Value = Depreciable Cost: $4,000 – $0 = $4,000. Depreciable Cost ÷ Useful Life = Depreciation Expense For One Year $4,000 ÷ 5 years = $800 per year. The asset was used for 6 months (7/1 – 12/31), therefore 1/2-year of depreciation expense should be reported. Annual depreciation X 6/12 = amount to be reported on 2010 income statement: $800 X 6/12 = $400.

14.

December 31		
Interest Receivable	10,000	
Interest Revenue		10,000
(To record accrued interest revenue on loan)		

Accrued expenses result from the same causes as accrued revenues. In fact, an accrued expense on the books of one company is an accrued revenue to another company.

15. No, all international companies are not subject to the same internal control standards. All public companies that list their securities on U.S. stock exchanges are subject to the internal control testing and assurance provisions of the Sarbanes-Oxley Act of 2002. International companies that list their securities on non-U.S. exchanges are not subject to these rules and there is debate as to whether they should have to comply.

16. There is concern that the cost of complying with the higher internal control provisions is making U.S. markets less competitive as a place to list securities. This in turn could give U.S. investors less investment opportunities. On the other hand, some argue that the enhanced internal control requirements in the U.S. increase the perceived reliability of companies' financial statements and helps reduce their cost of capital. Furthermore, the decline in public listings in the U.S. are more likely due to other factors, such as growth in non-U.S. markets and general globalization. Thus, the jury is still out on the net cost/benefit of Sarbanes-Oxley and its impact on international competitiveness.

17. As with accounting standards, there are differences in auditing standards across international jurisdictions. In the U.S., auditors of public companies are regulated by the Public Company Accounting Oversight Board (PCAOB). The PCAOB enforces the provisions of the Sarbanes-Oxley Act through its various auditing standards. In the international domain, the auditing standards board is the International Auditing and Assurance Standards Board (IAASB). The IAASB is working on a broad set of international auditing standards but to date does not have a law like Sarbanes-Oxley to guide its work.

Note to instructors—Some instructors may wish to direct students to the IAASB web-site http://www.ifac.org/iaasb/-to learn more about its work and to compare to the work of the PCAOB—http://www.pcaobus.org/.

***18.** Under the cash basis of accounting, revenue is recorded only when cash is received and expenses are recorded only when paid. Under the accrual basis of accounting, revenue is recognized when it is earned and expenses are recognized when incurred, without regard to the time of the receipt or payment of cash.

A cash-basis statement of financial position and income statement are incomplete and inaccurate in comparison to accrual-basis financial statements. The accrual basis matches effort (expenses) with accomplishment (revenues) in the income statement while the cash basis only presents cash receipts and cash disbursements. The accrual basis statement of financial position contains receivables, payables, accruals, prepayments, and deferrals while a cash basis statement of financial position shows none of these.

***19.** Wages paid during the year will include the payment of any wages attributable to the prior year but unpaid at the end of the prior year. This amount is an expense of the prior year and not of the current year, and thus should be subtracted in determining wages expense. Similarly, wages paid during the year will not include any wages attributable to hours worked during the current year but not actually paid until the following year. This should be added in determining wages expense.

***20.** Although similar to the strict cash basis, the modified cash basis of accounting requires that expenditures for capital items be charged against income over all the periods to be benefited. This is done through conventional accounting methods, such as depreciation and amortization. Under the strict cash basis, expenditures would be recognized as expenses in the period in which the corresponding cash disbursements are made.

***21.** Reversing entries are made at the beginning of the period to reverse accruals and some deferrals. Reversing entries are not required. They are made to simplify the recording of certain transactions that will occur later in the period. The same results will be attained whether or not reversing entries are recorded.

***22.** Disagree. A worksheet is not a permanent accounting record and its use is not required in the accounting cycle. The worksheet is an informal device for accumulating and sorting information needed for the financial statements. Its use is optional in helping to prepare financial statements.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 3-1

May	1	Cash	4,000	
		Share Capital		4,000
	3	Equipment	1,100	
		Accounts Payable		1,100
	13	Rent Expense	400	
		Cash		400
	21	Accounts Receivable	500	
		Service Revenue		500

BRIEF EXERCISE 3-2

Aug.	2	Cash	12,000	
		Equipment	2,500	
		Agazzi, Capital		14,500
	7	Supplies	500	
		Accounts Payable		500
	12	Cash	1,300	
		Accounts Receivable	670	
		Service Revenue		1,970

BRIEF EXERCISE 3-2 (Continued)

	15	Rent Expense	600	
		Cash		600
	19	Supplies Expense	230	
		Supplies ($500 – $270)		230

BRIEF EXERCISE 3-3

July	1	Prepaid Insurance	15,000	
		Cash		15,000
Dec.	31	Insurance Expense	2,500	
		Prepaid Insurance (€15,000 X 1/2 X 1/3)		2,500

BRIEF EXERCISE 3-4

July	1	Cash	15,000	
		Unearned Insurance Revenue		15,000
Dec.	31	Unearned Insurance Revenue	2,500	
		Insurance Revenue (€15,000 X 1/2 X 1/3)		2,500

BRIEF EXERCISE 3-5

Feb.	1	Prepaid Insurance	72,000	
		Cash		72,000
June	30	Insurance Expense	15,000	
		Prepaid Insurance (£72,000 X 5/24)		15,000

BRIEF EXERCISE 3-6

Nov.	1	Cash	2,400	
		Unearned Rent Revenue		2,400
Dec.	31	Unearned Rent Revenue	1,600	
		Rent Revenue ($2,400 X 2/3)		1,600

BRIEF EXERCISE 3-7

Dec.	31	Salaries Expense	4,800	
		Salaries Payable ($8,000 X 3/5)		4,800
Jan.	2	Salaries Payable	4,800	
		Salaries Expense	3,200	
		Cash		8,000

BRIEF EXERCISE 3-8

Dec.	31	Interest Receivable	300	
		Interest Revenue		300
Feb.	1	Cash	12,400	
		Notes Receivable		12,000
		Interest Receivable		300
		Interest Revenue		100

BRIEF EXERCISE 3-9

Aug.	31	Interest Expense	300	
		Interest Payable		300
	31	Accounts Receivable	1,400	
		Service Revenue		1,400
	31	Salaries Expense	700	
		Salaries Payable		700
	31	Bad Debt Expense	900	
		Allowance for Doubtful Accounts		900

BRIEF EXERCISE 3-10

Depreciation Expense	2,000	
Accumulated Depreciation—Equipment		2,000

Equipment	$30,000	
Less: Accumulated Depreciation—Equipment	2,000	$28,000

BRIEF EXERCISE 3-11

Sales	808,900	
Interest Revenue	13,500	
Income Summary		822,400
Income Summary	780,300	
Cost of Goods Sold		556,200
Operating Expenses		189,000
Income Tax Expense		35,100
Income Summary	42,100	
Retained Earnings		42,100
Retained Earnings	18,900	
Dividends		18,900

*BRIEF EXERCISE 3-12

(a)	Cash receipts	$142,000
	+ Increase in accounts receivable ($18,600 – $13,000)	5,600
	Service revenue	$147,600
(b)	Payments for operating expenses	$ 97,000
	– Increase in prepaid expenses ($23,200 – $17,500)	(5,700)
	Operating expenses	$ 91,300

*BRIEF EXERCISE 3-13

(a)	Salaries Payable	4,200	
	Salaries Expense		4,200
(b)	Salaries Expense	7,000	
	Cash		7,000
(c)	Salaries Payable	4,200	
	Salaries Expense	2,800	
	Cash		7,000

SOLUTIONS TO EXERCISES

EXERCISE 3-1 (15–20 minutes)

Apr.	2	Cash	30,000	
		Equipment	14,000	
		Christine Ewing, Capital		44,000
	2	No entry—not a transaction.		
	3	Supplies	700	
		Accounts Payable		700
	7	Rent Expense	600	
		Cash		600
	11	Accounts Receivable	1,100	
		Service Revenue		1,100
	12	Cash	3,200	
		Unearned Service Revenue		3,200
	17	Cash	2,300	
		Service Revenue		2,300
	21	Insurance Expense	110	
		Cash		110
	30	Salaries Expense	1,160	
		Cash		1,160

EXERCISE 3-1 (Continued)

30	Supplies Expense	120	
	Supplies		120
30	Equipment	5,100	
	Christine Ewing, Capital		5,100

EXERCISE 3-2 (10–15 minutes)

GERONIMO COMPANY
Trial Balance
April 30, 2010

	Debit	Credit
Cash	€ 2,100	
Accounts Receivable	2,750	
Prepaid Insurance (€700 + €1,000)	1,700	
Equipment	8,000	
Accounts Payable (€4,500 – €1,000)		€ 3,500
Property Tax Payable		560
Geronimo, Capital (€11,200 + €3,200)		14,400
Geronimo, Drawing	3,200	
Service Revenue		6,690
Salaries Expense	4,200	
Advertising Expense (€1,100 + €300)	1,400	
Property Tax Expense (€800 + €1,000)	1,800	
	€25,150	€25,150

EXERCISE 3-3 (15–20 minutes)

The ledger accounts are reproduced below, and corrections are shown in the accounts.

Cash

Bal.	5,912	(4)	190
(1)	270		

Accounts Payable

		Bal.	7,044

Accounts Receivable

Bal.	5,240	(1)	270

Share Capital—Ordinary

		Bal.	8,000

Supplies on Hand

Bal.	2,967		

Retained Earnings

		Bal.	2,000

Furniture and Equipment

Bal.	6,100		
(2)	1,900		

Service Revenue

		Bal.	5,200
		(3)	2,025
		(5)	80

Office Expense

Bal.	4,320	(2)	1,900

SCARLATTI CORPORATION
Trial Balance (Corrected)
April 30, 2010

	Debit	Credit
Cash	$ 5,992	
Accounts Receivable	4,970	
Supplies on Hand	2,967	
Furniture and Equipment	8,000	
Accounts Payable		$ 7,044
Share Capital—Ordinary		8,000
Retained Earnings		2,000
Service Revenue		7,305
Office Expense	2,420	
	$24,349	$24,349

EXERCISE 3-4 (15–20 minutes)

OAKLEY CO.
Trial Balance
June 30, 2010

	Debit	Credit
Cash ($2,870 + $360 – $65 – $65)	$ 3,100	
Accounts Receivable ($3,231 – $360)	2,871	
Supplies ($800 – $500)	300	
Equipment ($3,800 + $500)	4,300	
Accounts Payable ($2,666 – $206 – $260)		$ 2,200
Unearned Service Revenue ($1,200 – $225)		975
Share Capital—Ordinary		6,000
Dividends	575	
Retained Earnings		3,000
Service Revenue ($2,380 + $801 + $225)		3,406
Wages Expense ($3,400 + $670 – $575)	3,495	
Office Expense	940	
	$15,581	$15,581

EXERCISE 3-5 (10–15 minutes)

		Debit	Credit
1.	Depreciation Expense ($250 X 3)	750	
	Accumulated Depreciation—Equipment		750
2.	Unearned Rent Revenue ($6,300 X 1/3)	2,100	
	Rent Revenue		2,100
3.	Interest Expense	500	
	Interest Payable		500

EXERCISE 3-5 (Continued)

4.	Supplies Expense	2,150	
	Supplies ($2,800 – $650)		2,150
5.	Insurance Expense ($300 X 3)	900	
	Prepaid Insurance		900

EXERCISE 3-6 (10–15 minutes)

1.	Accounts Receivable	750	
	Service Revenue		750
2.	Utilities Expense	520	
	Utilities Payable		520
3.	Depreciation Expense	400	
	Accumulated Depreciation—Dental Equipment		400
	Interest Expense	500	
	Interest Payable		500
4.	Insurance Expense ($15,000 X 1/12)	1,250	
	Prepaid Insurance		1,250
5.	Supplies Expense ($1,600 – $400)	1,200	
	Supplies		1,200

EXERCISE 3-7 (15–20 minutes)

(a)

Ending balance of supplies	£ 900	
Add: Adjusting entry	950	
Deduct: Purchases	850	
Beginning balance of supplies	1,000	

(b)

Total prepaid insurance	£4,800	(£400 X 12)
Amount used (6 X £400)	2,400	
Present balance	2,400	

The policy was purchased six months ago (August 1, 2009)

(c) The entry in January to record salaries paid was

Salaries Expense	1,800	
Salaries Payable	900	
Cash		2,700

The "T" account for salaries payable is

Salaries Payable

Paid January	900	Beg. Bal.	?
		End Bal.	800

The beginning balance is therefore

Ending balance of salaries payable	£ 800
Plus: Reduction of salaries payable	900
Beginning balance of salaries payable	£1,700

EXERCISE 3-7 (Continued)

(d)

Service revenue	£2,000
Cash received	1,600
Unearned revenue reduced	£ 400

Ending unearned revenue January 31, 2010	£ 750
Plus: Unearned revenue reduced	400
Beginning unearned revenue December 31, 2009	£1,150

EXERCISE 3-8 (10–15 minutes)

(a)	Wages Expense	2,900	
	Wages Payable		2,900
(b)	Utilities Expense	600	
	Accounts Payable		600
(c)	Interest Expense ($60,000 X 8% X 1/12)	400	
	Interest Payable		400
(d)	Telephone Expense	117	
	Accounts Payable		117

EXERCISE 3-9 (15–20 minutes)

(a)	10/15	Salaries Expense	800	
		Cash		800
		(To record payment of October 15 payroll)		
	10/17	Accounts Receivable	2,100	
		Service Revenue		2,100
		(To record revenue for services performed for which payment has not yet been received)		
	10/20	Cash	650	
		Unearned Service Revenue		650
		(To record receipt of cash for services not yet performed)		
(b)	10/31	Supplies Expense	470	
		Supplies		470
		(To record the use of supplies during October)		
	10/31	Accounts Receivable	1,650	
		Service Revenue		1,650
		(To record revenue for services performed for which payment has not yet been received)		
	10/31	Salaries Expense	600	
		Salaries Payable		600
		(To record liability for accrued payroll)		
	10/31	Unearned Service Revenue	400	
		Service Revenue		400
		(To reduce the Unearned Service Revenue account for service that has been performed)		

EXERCISE 3-10 (25–30 minutes)

(a)	1.	Aug. 31	Insurance Expense (¥4,500 X 3/12)	1,125	
			Prepaid Insurance		1,125
	2.	Aug. 31	Supplies Expense (¥2,600 – ¥650)	1,950	
			Supplies		1,950
	3.	Aug. 31	Depreciation Expense—Cottages	1,080	
			Accumulated Depreciation—Cottages		1,080
			(¥120,000 – ¥12,000 = ¥108,000; ¥108,000 X 4% = ¥4,320 per year; ¥4,320 X 3/12 = ¥1,080)		
		Aug. 31	Depreciation Expense—Furniture	360	
			Accumulated Depreciation—Furniture		360
			(¥16,000 – ¥1,600 = ¥14,400; ¥14,400 X 10% = ¥1,440; ¥1,440 X 3/12 = ¥360)		
	4.	Aug. 31	Unearned Rent Revenue	3,800	
			Rent Revenue		3,800
	5.	Aug. 31	Salaries Expense	375	
			Salaries Payable		375
	6.	Aug. 31	Accounts Receivable	800	
			Rent Revenue		800
	7.	Aug. 31	Interest Expense	1,000	
			Interest Payable [(¥50,000 X 8%) X 3/12]		1,000

(b)

UHURA RESORT
Adjusted Trial Balance
August 31, 2010

	Debit	Credit
Cash	¥ 19,600	
Accounts Receivable	800	
Prepaid Insurance (¥4,500 – ¥1,125)	3,375	
Supplies (¥2,600 – ¥1,950)	650	
Land	20,000	
Cottages	120,000	
Accumulated Depreciation—Cottages		¥ 1,080
Furniture	16,000	
Accumulated Depreciation—Furniture		360
Accounts Payable		4,500
Unearned Rent Revenue (¥4,600 – ¥3,800)		800
Salaries Payable		375
Interest Payable		1,000
Mortgage Payable		50,000
Share Capital—Ordinary		100,000
Retained Earnings		
Dividends	5,000	
Rent Revenue (¥86,200 + ¥3,800 + ¥800)		90,800
Salaries Expense (¥44,800 + ¥375)	45,175	
Utilities Expense	9,200	
Repair Expense	3,600	
Insurance Expense	1,125	
Supplies Expense	1,950	
Depreciation Expense—Cottages	1,080	
Depreciation Expense—Furniture	360	
Interest Expense	1,000	
	¥248,915	¥248,915

EXERCISE 3-11 (20–25 Minutes)

(a)

CAVAMANLIS CO.
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		$12,590
Expenses		
Salaries expense	$6,840	
Rent expense	2,760	
Depreciation expense	145	
Interest expense	83	9,828
Net Income		$ 2,762

(b)

CAVAMANLIS CO.
Statement of Retained Earnings
For the Year Ended December 31, 2010

Retained earnings, January 1	$11,310
Add: Net income	2,762
Less: Dividends	3,000
Retained earnings, December 31	$11,072

(c)

CAVAMANLIS CO.
Statement of Financial Position
December 31, 2010

Assets

Noncurrent assets		
Property, plant, and equipment		
Equipment	$18,050	
Less: Accumulated depreciation	4,895	$13,155
Current assets		
Prepaid rent	2,280	
Accounts receivable	6,920	
Cash	18,972	
Total current assets		28,172
Total assets		$41,327

Equity and Liabilities

Equity		
Share capital—ordinary	$20,000	
Retained earnings	11,072*	$31,072
Current liabilities		
Notes payable	5,700	
Accounts payable	4,472	
Interest payable	83	
Total current liabilities		10,255
Total equity and liabilities		$41,327

*Beg. Balance + Net Income – Dividends = Ending Balance
$11,310 + $2,762 – $3,000 = $11,072

EXERCISE 3-12 (20–25 Minutes)

(a)

FLYNN DESIGN AGENCY
Income Statement
For the Year Ended December 31, 2010

Revenues		
Advertising revenue		$58,500
Expenses		
Salaries expense..	$12,300	
Depreciation expense	7,000	
Rent expense	4,000	
Art supplies expense....................................	3,400	
Insurance expense..	850	
Interest expense...	500	
Total expenses		28,050
Net income		$30,450

FLYNN DESIGN AGENCY
Statement of Retained Earnings
For the Year Ended December 31, 2010

Retained earnings, January 1..	$ 3,500
Add: Net income...	30,450
Retained earnings, December 31	$33,950

(a) (Continued)

FLYNN DESIGN AGENCY
Statement of Financial Position
December 31, 2010

Assets		
Printing equipment	$60,000	
Less: Accumulated depreciation—printing equipment	35,000	$25,000
Art supplies		5,000
Prepaid insurance		2,500
Accounts receivable		21,500
Cash		10,000
Total assets		$64,000
Equity and Liabilities		
Equity		
Share capital—ordinary	$10,000	
Retained earnings	33,950	$43,950
Liabilities		
Notes payable	5,000	
Accounts payable	8,000	
Unearned advertising revenue	5,600	
Salaries payable	1,300	
Interest payable	150	
Total liabilities		20,050
Total equity and liabilities		$64,000

(b) 1. Based on interest payable at December 31, 2010, interest is $25 per month or .5% of the note payable. .5% X 12 = 6% interest per year.

2. Salaries Expense, $12,300 less Salaries Payable 12/31/10, $1,300 = $11,000. Total Payments, $17,500 – $11,000 = $6,500 Salaries Payable 12/31/09.

EXERCISE 3-13 (10–15 Minutes)

(a)	Sales		$800,000
	Less: Sales returns and allowances	$24,000	
	Sales discount	12,000	36,000
	Net sales		$764,000

(b)	Sales	800,000	
	Income Summary		800,000
	Income Summary	36,000	
	Sales Returns and Allowances		24,000
	Sales Discounts		12,000

EXERCISE 3-14 (10–15 minutes)

Sales	340,000	
Sales Returns and Allowances		13,000
Sales Discounts		8,000
Income Summary		319,000
Income Summary	302,000	
Cost of Goods Sold		202,000
Freight-out		7,000
Insurance Expense		12,000
Rent Expense		20,000
Salary Expense		61,000
Income Summary	17,000	
Retained Earnings		17,000

EXERCISE 3-15 (10–15 minutes)

(a) $5,000 ($90,000 – $85,000)
(b) $29,000 ($85,000 – $56,000)
(c) $14,000 ($29,000 – $15,000)
(d) $95,000 ($5,000 + $90,000)
(e) $52,000 ($90,000 – $38,000)

EXERCISE 3-16 (10–15 minutes)

Sales	390,000	
Cost of Goods Sold		235,700
Sales Returns and Allowances		12,000
Sales Discounts		15,000
Selling Expenses		16,000
Administrative Expenses		38,000
Income Tax Expense		30,000
Income Summary		43,300

(or)

Sales	390,000	
Income Summary		390,000
Income Summary	346,700	
Cost of Goods Sold		235,700
Sales Returns and Allowances		12,000
Sales Discounts		15,000
Selling Expenses		16,000
Administrative Expenses		38,000
Income Tax Expense		30,000
Income Summary	43,300	
Retained Earnings		43,300
Retained Earnings	18,000	
Dividends		18,000

EXERCISE 3-17 (10–15 minutes)

Mar.	1	Cash	60,000	
		Share Capital—Ordinary		60,000
		(Investment of cash in business)		
	3	Land	10,000	
		Building	22,000	
		Equipment	6,000	
		Cash		38,000
		(Purchased Michelle Wie's Golf Land)		
	5	Advertising Expense	1,600	
		Cash		1,600
		(Paid for advertising)		
	6	Prepaid Insurance	1,480	
		Cash		1,480
		(Paid for one-year insurance policy)		
	10	Equipment	2,500	
		Accounts Payable		2,500
		(Purchased equipment on account)		
	18	Cash	1,200	
		Service Revenue		1,200
		(Received cash for services performed)		
	25	Dividends	1,000	
		Cash		1,000
		(Declared and paid a £1,000 cash dividend)		
	30	Wages Expense	900	
		Cash		900
		(Paid wages expense)		
	30	Accounts Payable	2,500	
		Cash		2,500
		(Paid creditor on account)		
	31	Cash	750	
		Service Revenue		750
		(Received cash for services performed)		

*EXERCISE 3-18 (15–20 minutes)

CORINNE DUNBAR, M.D.
Conversion of Cash Basis to Accrual Basis
For the Year 2010

Excess of cash collected over cash disbursed ($142,600 – $60,470)	$82,130
Add increase in accounts receivable ($11,250 – $15,927)	4,677
Deduct increase in unearned service revenue ($2,840 – $4,111)	(1,271)
Add decrease in accrued expenses ($3,435 – $2,108)	1,327
Add increase in prepaid expenses ($1,917 – $3,232)	1,315
Net income on an accrual basis	$88,178

Alternate solution:

CORINNE DUNBAR, M.D.
Conversion of Income Statement Data
from Cash Basis to Accrual Basis
For the Year 2010

	Cash Basis	Adjustments Add	Adjustments Deduct	Accrual Basis
Collections from customers:	$142,600			
–Accounts receivable, Jan. 1			$11,250	
+Accounts receivable, Dec. 31		$15,927		
+Unearned service revenue, Jan. 1		2,840		
–Unearned service revenue, Dec. 31			4,111	
Service revenue				$146,006
Disbursements for expenses:	60,470			
–Accrued liabilities, Jan. 1			3,435	
+Accrued liabilities, Dec. 31		2,108		
+Prepaid expenses, Jan. 1		1,917		
–Prepaid expenses, Dec. 31			3,232	
Operating expenses				57,828
Net income—cash basis	$ 82,130			$ 88,178
Net income—accrual basis				

*EXERCISE 3-19 (10–15 minutes)

(a)

NALEZNY CORP.
Income Statement (Cash Basis)
For the Year Ended December 31,

	2009	2010
Sales	$290,000	$515,000
Expenses	225,000	282,000
Net income	$ 65,000	$233,000

(b)

NALEZNY CORP.
Income Statement (Accrual Basis)
For the Year Ended December 31,

	2009	2010
Sales*	$480,000	$445,000
Expenses**	277,000	265,000
Net income	$203,000	$180,000

*2009: $290,000 + $160,000 + $30,000 = $480,000
2010: $355,000 + $90,000 = $445,000
**2009: $185,000 + $67,000 + $25,000 = $277,000
2010: $40,000 + $170,000 + $55,000 = $265,000

***EXERCISE 3-20 (20–25 minutes)**

(a) Adjusting Entries:

		Debit	Credit
1.	Insurance Expense ($6,000 X 5/24)	1,250	
	Prepaid Insurance		1,250
2.	Rental Revenue ($2,400 X 1/3)	800	
	Unearned Rental Revenue		800
3.	Advertising Materials	290	
	Advertising Expense		290
4.	Interest Expense	770	
	Interest Payable		770

(b) Reversing Entries:

1. No reversing entry required.

2.	Unearned Rental Revenue	800	
	Rental Revenue		800
3.	Advertising Expense	290	
	Advertising Materials		290
4.	Interest Payable	770	
	Interest Expense		770

*EXERCISE 3-21 (10–15 minutes)

Accounts	Adjusted Trial Balance		Income Statement		Statement of Financial Position	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,000				15,000	
Merchandise Inventory	80,000				80,000	
Sales		470,000		470,000		
Sales Returns and Allowances	10,000		10,000			
Sales Discounts	5,000		5,000			
Cost of Goods Sold	250,000		250,000			

*EXERCISE 3-22 (20–25 minutes)

MADRASAH CO.
Worksheet (Partial)
For the Month Ended April 30, 2010

	Adjusted Trial Balance		Income Statement		Statement of Financial Position	
Account Titles	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	18,972				18,972	
Accounts Receivable	6,920				6,920	
Prepaid Rent	2,280				2,280	
Equipment	18,050				18,050	
Accum. Depreciation		4,895				4,895
Notes Payable		5,700				5,700
Accounts Payable		4,472				4,472
Madrasah, Capital		34,960				34,960
Madrasah, Drawing	6,650				6,650	
Service Revenue		12,590		12,590		
Salaries Expense	6,840		6,840			
Rent Expense	2,760		2,760			
Depreciation Expense	145		145			
Interest Expense	83		83			
Interest Payable		83				83
Totals	62,700	62,700	9,828	12,590	52,872	50,110
Net Income			2,762			2,762
Totals			12,590	12,590	52,872	52,872

*EXERCISE 3-22 (Continued)

MADRASAH CO.
Statement of Financial Position
April 30, 2010

Assets		
Noncurrent Assets		
Property, plant, and equipment		
Equipment	$18,050	
Less Accumulated depreciation	4,895	$13,155
Current Assets		
Prepaid rent	2,280	
Accounts receivable	6,920	
Cash	18,972	
Total current assets		28,172
Total assets		$41,327
Equity and Liabilities		
Equity		
Madrasah, Capital		$31,072*
Current liabilities		
Notes payable	$ 5,700	
Accounts payable	4,472	
Interest payable	83	
Total current liabilities		10,255
Total equity and liabilities		$41,327

*Beg. Balance – Drawings + Net Income = Ending Balance
$34,960 – $6,650 + $2,762 = $31,072

*EXERCISE 3-23 (10–15 minutes)

LETTERMAN CO.
Worksheet (Partial)
For Month Ended February 28, 2010

	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Statement of Financial Position	
Account Titles	**Dr.**	**Cr.**	**Dr.**	**Cr.**	**Dr.**	**Cr.**	**Dr.**	**Cr.**	**Dr.**	**Cr.**
Supplies	1,756			(a) 1,241	515				515	
Accumulated Depreciation		7,967		(b) 257		8,224				8,224
Interest Payable		150		(c) 50		200				200
Supplies Expense			(a) 1,241		1,241		1,241			
Depreciation Expense			(b) 257		257		257			
Interest Expense			(c) 50		50		50			

The following accounts and amounts would be shown in the February income statement:

Supplies expense......................................	$1,241
Depreciation expense..............................	257
Interest expense..	50

TIME AND PURPOSE OF PROBLEMS

Problem 3-1 (Time 25–35 minutes)
Purpose—to provide an opportunity for the student to post daily transactions to a “T” account ledger, take a trial balance, prepare an income statement, a statement of financial position and a statement of changes in equity, close the ledger, and take a post-closing trial balance. The problem deals with routine transactions of a professional service firm and provides a good integration of the accounting process.

Problem 3-2 (Time 35–40 minutes)
Purpose—to provide an opportunity for the student to prepare adjusting entries, and prepare financial statements (income statement, statement of financial position, and statement of retained earnings). The student also is asked to analyze two transactions to find missing amounts.

Problem 3-3 (Time 25–30 minutes)
Purpose—to provide an opportunity for the student to prepare adjusting entries. The adjusting entries are fairly complex in nature.

Problem 3-4 (Time 40–50 minutes)
Purpose—to provide an opportunity for the student to prepare adjusting entries and an adjusted trial balance and then prepare an income statement, a retained earnings statement, and a statement of financial position. In addition, closing entries must be made and a post-closing trial balance prepared.

Problem 3-5 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to determine what adjusting entries need to be made to specific accounts listed in a partial trial balance. The student is also required to determine the amounts of certain revenue and expense items to be reported in the income statement.

Problem 3-6 (Time 25–35 minutes)
Purpose—to provide the student with an opportunity to prepare year-end adjusting entries from a trial balance and related information presented. The problem also requires the student to prepare an income statement, a statement of financial position, and a statement of changes in equity. The problem covers the basics of the end-of-period adjusting process.

Problem 3-7 (Time 25–35 minutes)
Purpose—to provide an opportunity for the student to figure out the year-end adjusting entries that were made from a trial balance and an adjusted trial balance. The student is also required to prepare an income statement, a statement of retained earnings, and a statement of financial position. In addition, the student needs to answer a number of questions related to specific accounts.

Problem 3-8 (Time 30–40 minutes)
Purpose—to provide an opportunity for the student to prepare adjusting, and closing entries. This problem presents basic adjustments including a number of accruals and deferrals. It provides the student with an integrated flow of the year-end accounting process.

Problem 3-9 (Time 30–35 minutes)
Purpose—to provide an opportunity for the student to prepare adjusting and closing entries from a trial balance and related information. The student is also required to post the entries to “T” accounts.

***Problem 3-10** (Time 35–40 minutes)
Purpose—to provide an opportunity for the student to prepare and compare (a) cash basis and accrual basis income statements, (b) cash basis and accrual basis statement of financial position, and (c) to discuss the weaknesses of cash basis accounting.

***Problem 3-11** (Time 40–50 minutes)
Purpose—to provide an opportunity for the student to complete a worksheet and then prepare a classified statement of financial position. In addition, adjusting and closing entries must be made and a post-closing trial balance prepared.

SOLUTIONS TO PROBLEMS

PROBLEM 3-1

(a) (Explanations are omitted.) and (d)

Cash

Sept.	1	20,000	Sept.	4	680
	8	1,690		5	942
	20	980		10	430
				18	3,600
				19	3,000
				30	1,800
				30	85
	30 Bal.	12,133			

Furniture and Equipment

Sept.	2	17,280			

Yasunari Kawabata, Capital

Sept.	19	3,000	Sept.	1	20,000
				30	6,007
			Bal.	30	23,007

Accounts Receivable

Sept.	14	5,820	Sept.	20	980
	25	2,110			
Bal.	30	6,950			

Accounts Payable

Sept.	18	3,600	Sept.	2	17,280
			Bal.	30	13,680

Rent Expense

Sept.	4	680	Sept.	30	680

Supplies on Hand

Sept.	5	942	Sept.	30	330
Bal.	30	612			

Service Revenue

Sept.	30	9,620	Sept.	8	1,690
				14	5,820
				25	2,110
		9,620			9,620

Miscellaneous Office Expense

Sept.	10	430	Sept.	30	515
	30	85			
		515			515

Accumulated Depreciation

			Sept.	30	288

Office Salaries Expense

Sept.	30	1,800	Sept.	30	1,800

Supplies Expense

Sept.	30	330	Sept.	30	330

Depreciation Expense

Sept.	30	288	Sept.	30	288

Income Summary

Sept.	30		680	Sept.	30	9,620
	30		515			
	30		1,800			
	30		330			
	30		288			
	30	Inc.	6,007			
			9,620			9,620

(b)

YASUNARI KAWABATA, D.D.S.
Trial Balance
September 30

	Debit	Credit
Cash	¥12,133	
Accounts Receivable	6,950	
Supplies on Hand	612	
Furniture and Equipment	17,280	
Accumulated Depreciation		¥ 288
Accounts Payable		13,680
Yasunari Kawabata, Capital		17,000
Service Revenue		9,620
Rent Expense	680	
Miscellaneous Office Expense	515	
Office Salaries Expense	1,800	
Supplies Expense	330	
Depreciation Expense	288	
Totals	¥40,588	¥40,588

(c)

YASUNARI KAWABATA, D.D.S.
Income Statement
For the Month of September

Service revenue		¥9,620
Expenses:		
Office salaries expense	¥1,800	
Rent expense	680	
Supplies expense	330	
Depreciation expense	288	
Miscellaneous office expense	515	
Total expenses		3,613
Net income		¥6,007

YASUNARI KAWABATA, D.D.S.
Statement of Owner's Equity
For the Month of September

Kawabata, Capital September 1	¥20,000
Add: Net income for September	6,007
	26,007
Less: Withdrawal by owner	3,000
Kawabata, Capital September 30	¥23,007

YASUNARI KAWABATA, D.D.S.
Statement of Financial Position
As of September 30

Assets		Equity and Liabilities	
Furniture and equip.	¥17,280	Yasunari Kawabata,	
Accum. depreciation	(288)	Capital	¥23,007
Supplies on Hand	612	Accounts payable	13,680
Accounts receivable	6,950		
Cash	12,133	Total equity and	
Total assets	¥36,687	liabilities	¥36,687

(e)

YASUNARI KAWABATA, D.D.S.
Post-Closing Trial Balance
September 30

	Debit	Credit
Cash	¥12,133	
Accounts Receivable	6,950	
Supplies on Hand	612	
Furniture and Equipment	17,280	
Accumulated Depreciation		¥ 288
Accounts Payable		13,680
Yasunari Kawabata, Capital		23,007
Totals	¥36,975	¥36,975

PROBLEM 3-2

(a)	Dec. 31	Accounts Receivable	3,500	
		Advertising Revenue		3,500
	31	Unearned Advertising Revenue	1,400	
		Advertising Revenue		1,400
	31	Art Supplies Expense	5,400	
		Art Supplies		5,400
	31	Depreciation Expense	5,000	
		Accumulated Depreciation		5,000
	31	Interest Expense	150	
		Interest Payable		150
	31	Insurance Expense	850	
		Prepaid Insurance		850
	31	Salaries Expense	1,300	
		Salaries Payable		1,300

PROBLEM 3-2 (Continued)

(b)

MASON ADVERTISING AGENCY
Income Statement
For the Year Ended December 31, 2010

Revenues		
Advertising revenue		$63,500
Expenses		
Salaries expense	$11,300	
Art supplies expense	5,400	
Depreciation expense	5,000	
Rent expense	4,000	
Insurance expense	850	
Interest expense	500	
Total expenses		27,050
Net income		$36,450

MASON ADVERTISING AGENCY
Statement of Retained Earnings
For the Year Ended December 31, 2010

Retained earnings, January 1	$ 3,500
Add: Net income	36,450
Retained earnings, December 31	$39,950

PROBLEM 3-2 (Continued)

MASON ADVERTISING AGENCY
Statement of Financial Position
December 31, 2010

Assets		
Printing equipment	$60,000	
Less: Accumulated depreciation—printing equipment	33,000	$27,000
Art supplies		3,000
Prepaid insurance		2,500
Accounts receivable		23,500
Cash		11,000
Total assets		$67,000
Equity and Liabilities		
Equity		
Share capital—ordinary	$10,000	
Retained earnings	39,950	$49,950
Liabilities		
Notes payable	5,000	
Accounts payable	5,000	
Unearned advertising revenue	5,600	
Salaries payable	1,300	
Interest payable	150	
Total liabilities		17,050
Total equity and liabilities		$67,000

(c) 1. Interest is $50 per month or 1% of the note payable. 1% X 12 = 12% interest per year.

2. Salaries Expense, $11,300 less Salaries Payable 12/31/10, $1,300 = $10,000. Total Payments, $12,500 – $10,000 = $2,500 Salaries Payable 12/31/09.

PROBLEM 3-3

1.	Dec.	31	Salaries Expense	2,120	
			Salaries Payable		2,120
			(5 X $700 X 2/5) = $1,400		
			(3 X $600 X 2/5) = 720		
			Total accrued salaries $2,120		
2.		31	Unearned Rent Revenue	94,000	
			Rent Revenue		94,000
			(5 X $6,000 X 2) = $60,000		
			(4 X $8,500 X 1) = 34,000		
			Total rent earned $94,000		
3.		31	Advertising Expense	4,900	
			Prepaid Advertising		4,900
			(A650 – $500 per month for 8 months) = $4,000		
			(B974 – $300 per month for 3 months) = 900		
			Total advertising expense $4,900		
4.		31	Interest Expense	4,200	
			Interest Payable ($60,000 X 12% X 7/12)		4,200

PROBLEM 3-4

(a)	Nov.	30	Store Supplies Expense	4,000	
			Store Supplies		4,000
		30	Depr. Expense—Store Equipment	9,000	
			Accumulated Depreciation—Store Equipment		9,000
		30	Depr. Expense—Delivery Equipment	6,000	
			Accumulated Depreciation—Delivery Equipment		6,000
		30	Interest Expense	11,000	
			Interest Payable		11,000

(b)

BELLEMY FASHION CENTER
Adjusted Trial Balance
November 30, 2010

	Dr.	Cr.
Cash	€ 28,700	
Accounts Receivable	33,700	
Merchandise Inventory	45,000	
Store Supplies	1,500	
Store Equipment	85,000	
Accumulated Depr.—Store Equipment		€ 27,000
Delivery Equipment	48,000	
Accumulated Depr.—Delivery Equipment		12,000
Notes Payable		51,000
Accounts Payable		48,500
Share Capital—Ordinary		90,000
Retained Earnings		8,000
Sales		757,200
Sales Returns and Allowances	4,200	
Cost of Goods Sold	495,400	
Salaries Expense	140,000	
Advertising Expense	26,400	
Utilities Expense	14,000	
Repair Expense	12,100	
Delivery Expense	16,700	
Rent Expense	24,000	
Store Supplies Expense	4,000	
Depreciation Expense—Store Equipment	9,000	
Depreciation Expense—Delivery Equipment	6,000	
Interest Expense	11,000	
Interest Payable		11,000
Totals	€1,004,700	€1,004,700

(c)

BELLEMY FASHION CENTER
Income Statement
For the Year Ended November 30, 2010

Sales revenue		
Sales		€757,200
Less: Sales returns and allowances		4,200
Net sales		753,000
Cost of goods sold		495,400
Gross profit		257,600
Operating expenses		
Selling expenses		
Salaries expense (€140,000 X 70%)	€98,000	
Advertising expense	26,400	
Rent expense (€24,000 X 80%)	19,200	
Delivery expense	16,700	
Utilities expense (€14,000 X 80%)	11,200	
Depr. exp.—store equipment	9,000	
Depr. exp.—deliv. equipment	6,000	
Store supplies expense	4,000	190,500
Administrative expenses		
Salaries expense (€140,000 X 30%)	42,000	
Repair expense	12,100	
Rent expense (€24,000 X 20%)	4,800	
Utilities expense (€14,000 X 20%)	2,800	61,700
Other income and expense		
Interest expense		11,000
Net loss		(€ 5,600)

PROBLEM 3-4 (Continued)

BELLEMY FASHION CENTER
Retained Earnings Statement
For the Year Ended November 30, 2010

Retained earnings, December 1, 2009	€8,000
Less: Net loss	5,600
Retained earnings, November 30, 2010	€2,400

BELLEMY FASHION CENTER
Statement of Financial Position
November 30, 2010

Assets			
Noncurrent assets			
Property, plant, and equipment			
Store equipment	$85,000		
Accum. depr.—store equipment	27,000	€58,000	
Delivery equipment	48,000		
Accum. depr.—delivery equipment	12,000	36,000	€ 94,000
Current assets			
Store supplies		1,500	
Merchandise inventory		45,000	
Accounts receivable		33,700	
Cash		28,700	
Total current assets			108,900
Total assets			€202,900
Equity and Liabilities			
Equity			
Share capital—ordinary		€90,000	
Retained earnings		2,400	€ 92,400
Noncurrent Liabilities			
Notes payable		21,000	
Current Liabilities			
Notes payable due next year	€30,000		
Accounts payable	48,500		
Interest payable	11,000		
Total current liabilities		89,500	
Total liabilities			110,500
Total equity and liabilities			€202,900

PROBLEM 3-4 (Continued)

(d)	Nov.	30	Sales	757,200	
			Income Summary		757,200
		30	Income Summary	762,800	
			Sales Returns and Allowances		4,200
			Cost of Goods Sold		495,400
			Salaries Expense		140,000
			Advertising Expense		26,400
			Utilities Expense		14,000
			Repair Expense		12,100
			Delivery Expense		16,700
			Rent Expense		24,000
			Store Supplies Expense		4,000
			Depreciation Expense—Store Equipment		9,000
			Depreciation Expense—Delivery Equipment		6,000
			Interest Expense		11,000
		30	Retained Earnings	5,600	
			Income Summary		5,600

(e)

BELLEMY FASHION CENTER
Post-Closing Trial Balance
November 30, 2010

	Debit	Credit
Cash	€ 28,700	
Accounts Receivable	33,700	
Merchandise Inventory	45,000	
Store Supplies	1,500	
Store Equipment	85,000	
Accumulated Depreciation—Store Equipment		€ 27,000
Delivery Equipment	48,000	
Accumulated Depreciation—Delivery Equipment		12,000
Notes Payable		51,000
Accounts Payable		48,500
Interest Payable		11,000
Share Capital—Ordinary		90,000
Retained Earnings		2,400
	€241,900	€241,900

PROBLEM 3-5

(a)

	Debit	Credit
-1-		
Depreciation Expense	10,500	
Accumulated Depreciation—Equipment (1/16 X [$192,000 – $24,000])		10,500
-2-		
Interest Expense	1,440*	
Interest Payable ($90,000 X 8% X 72/360)		1,440*
-3-		
Admissions Revenue	60,000	
Unearned Admissions Revenue (2,000 X $30)		60,000
-4-		
Prepaid Advertising	1,100	
Advertising Expense		1,100
-5-		
Salaries Expense	4,700	
Salaries Payable		4,700

(b) 1. Interest expense, $2,840 ($1,400 + $1,440).
2. Admissions revenue, $320,000 ($380,000 – $60,000).
3. Advertising expense, $12,580 ($13,680 – $1,100).
4. Salaries expense, $62,300 ($57,600 + $4,700).

*Note to instructor: If 30-day months are assumed, interest expense = $1,400 ($90,000 X 8% X 70/360).

PROBLEM 3-6

(a)

	-1-		
Service Revenue		6,000	
	Unearned Service Revenue		6,000
	-2-		
Accounts Receivable		4,900	
	Service Revenue		4,900
	-3-		
Bad Debt Expense		1,430	
	Allowance for Doubtful Accounts		1,430
	-4-		
Insurance Expense		480	
	Prepaid Insurance		480
	-5-		
Depreciation Expense—Furniture and Equipment		2,500	
	Accum. Depr.—Furniture and Equipment ($25,000 X .10)		2,500
	-6-		
Interest Expense		60	
	Interest Payable ($7,200 X .10 X 30/360)		60
	-7-		
Prepaid Rent		750	
	Rent Expense		750
	-8-		
Office Salaries Expense		2,510	
	Salaries Payable		2,510

PROBLEM 3-6 (Continued)

(b)

YORKIS PEREZ, CONSULTING ENGINEER
Income Statement
For the Year Ended December 31, 2010

Service revenue ($100,000 – $6,000 + $4,900)		$98,900
Expenses		
Office salaries expense ($30,500 + $2,510)	$33,010	
Rent expense ($9,750 – $750)	9,000	
Depreciation expense	2,500	
Bad debt expense	1,430	
Heat, light, and water expense	1,080	
Miscellaneous office expense	720	
Insurance expense	480	
Interest expense	60	
Total expenses		48,280
Net income		$50,620

YORKIS PEREZ, CONSULTING ENGINEER
Statement of Changes in Equity
For the Year Ended December 31, 2010

Yorkis Perez, Capital, January 1	$ 52,010[a]
Add: Net income	50,620
Less: Withdrawals	17,000
Yorkis Perez, Capital, December 31	$ 85,630

[(a)]Yorkis Perez, Capital—trial balance	$35,010
Withdrawals during the year	(17,000)
Yorkis Perez, Capital, as of January 1, 2010	$52,010

PROBLEM 3-6 (Continued)

YORKIS PEREZ, CONSULTING ENGINEER
Statement of Financial Position
December 31, 2010

Assets			
Noncurrent assets			
Furniture and equipment		$25,000	
Less: Accum. depreciation		8,750**	$ 16,250
Current assets			
Engineering supplies inventory		1,960	
Prepaid insurance ($1,100 – $480)		620	
Prepaid rent		750	
Accounts receivable ($49,600 + $4,900)	$54,500		
Less: Allowance for doubtful accounts	2,180*	52,320	
Cash		29,500	
Total current assets			85,150
Total assets			$101,400
Equity and Liabilities			
Equity			
Yorkis Perez, Capital ($35,010 + $50,620)			$ 85,630
Liabilities			
Current liabilities			
Notes payable		$7,200	
Unearned service revenue		6,000	
Salaries payable		2,510	
Interest payable		60	15,770
Total equity and liabilities			$101,400

*($750 + $1,430)
**($6,250 + $2,500)

PROBLEM 3-7

(a)	Dec. 31	Account Receivable	1,000	
		Service Revenue		1,000
	31	Unearned Service Revenue	1,400	
		Service Revenue		1,400
	31	Art Supplies Expense	5,000	
		Art Supplies		5,000
	31	Depreciation Expense	8,750	
		Accumulated Depreciation—Printing Equipment		8,750
	31	Interest Expense	150	
		Interest Payable		150
	31	Insurance Expense	750	
		Prepaid Insurance		750
	31	Salaries Expense	1,500	
		Salaries Payable		1,500

(b)

SORENSTAM ADVERTISING CORP.
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		€61,000
Expenses		
Salaries expense	€11,500	
Art supplies expense	10,000	
Depreciation expense	8,750	
Rent expense	4,000	
Insurance expense	750	
Interest expense	500	
Total expenses		35,500
Net income		€25,500

SORENSTAM ADVERTISING CORP.
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1	€ 4,500
Add: Net income	25,500
Retained earnings, December 31	€30,000

SORENSTAM ADVERTISING CORP.
Statement of Financial Position
December 31, 2010

Assets

Printing equipment	€60,000	
Less: Accum. depr.—printing equipment	35,750	€24,250
Prepaid insurance		2,500
Art supplies		3,500
Accounts receivable		20,000
Cash		7,000
Total assets		€57,250

Equity and Liabilities

Equity		
Share capital—ordinary	€10,000	
Retained earnings	30,000	
Total equity		€40,000
Liabilities		
Notes payable	5,000	
Accounts payable	5,000	
Unearned service revenue	5,600	
Salaries payable	1,500	
Interest payable	150	
Total liabilities		17,250
Total equity and liabilities		€57,250

PROBLEM 3-7 (Continued)

(c) 1. Total depreciable cost = €8,750 X 6 = €52,500.

Salvage value = cost €60,000 less depreciable cost €52,500 = €7,500

2. Based on the balance in interest payable, interest is €50 per month or 1% of the note payable.
1% X 12 = 12% interest per year.

3. Salaries Expense, €11,500 less Salaries Payable 12/31/10, €1,500 = €10,000. Total payments, €12,500 – €10,000 = €2,500 Salaries Payable 12/31/09.

*PROBLEM 3-8

(a), (b), (d)

Cash

Bal.	15,000		

Prepaid Insurance

Bal.	9,000	Adj.	3,500
	5,500		

Salaries Expense

Bal.	80,000	Close	83,600
Adj.	3,600		
	83,600		83,600

Share Capital—Ordinary

		Bal.	400,000

Accounts Receivable

Bal.	13,000		

Retained Earnings

		Bal.	82,000
		Inc.	31,640
			113,640

Maintenance Expense

Bal.	24,000	Close	24,000

Allow. for Doubtful Accts.

		Bal.	1,100
		Adj.	460
			1,560

Dues Revenue

Adj.	8,900	Bal.	200,000
Cls.	191,100		
	200,000		200,000
		Rev.	8,900

Depr. Expense—Buildings

Adj.	4,000	Close	4,000

Land

Bal.	350,000		

Greens Fee Revenue

Close	5,900	Bal.	5,900

Depr. Expense—Equipment

Adj.	15,000	Close	15,000

Buildings

Bal.	120,000		

Rental Revenue

Close	19,200	Bal.	17,600
		Adj.	1,600
	19,200		19,200
Rev.	1,600		

Accum. Depr.—Equipment

		Bal.	70,000
		Adj.	15,000
			85,000

Accum. Depr.—Buildings

		Bal.	38,400
		Adj.	4,000
			42,400

Utilities Expense

Bal.	54,000	Close	54,000

Insurance Expense

Adj.	3,500	Close	3,500

Rent Receivable

Adj.	$1,600	Rev.	1,600

Bad Debt Expense

Adj.	460	Close	460

Income Summary

Exp.	184,560	Rev.	216,200
Inc.	31,640		
	216,200		216,200

*PROBLEM 3-8 (Continued)

Salaries Payable	
	Adj. 3,600

Unearned Dues Revenue	
	Adj. 8,900

Equipment	
Bal. 150,000	

(b)

-1-

Depreciation Expense—Buildings	4,000	
Accumulated Depreciation—Buildings (1/30 X $120,000)		4,000

-2-

Depreciation Expense—Equipment	15,000	
Accumulated Depreciation—Equipment (10% X $150,000)		15,000

-3-

Insurance Expense	3,500	
Prepaid Insurance		3,500

-4-

Rent Receivable	1,600	
Rental Revenue (1/11 X $17,600)		1,600

-5-

Bad Debt Expense	460	
Allowance for Doubtful Accounts [($13,000 X 12%) – $1,100]		460

-6-

Salaries Expense	3,600	
Salaries Payable		3,600

-7-

Dues Revenue	8,900	
Unearned Dues Revenue		8,900

(c)

CRESTWOOD GOLF CLUB, INC.
Adjusted Trial Balance
December 31, XXXX

	Dr.	Cr.
Cash	$ 15,000	
Accounts Receivable	13,000	
Allowance for Doubtful Accounts		$ 1,560
Prepaid Insurance	5,500	
Land	350,000	
Building	120,000	
Accum. Depreciation—Buildings		42,400
Equipment	150,000	
Accum. Depreciation—Equipment		85,000
Salaries Payable		3,600
Share Capital—Ordinary		400,000
Retained Earnings		82,000
Dues Revenue		191,100
Greens Fee Revenue		5,900
Rental Revenue		19,200
Utilities Expense	54,000	
Salaries Expense	83,600	
Maintenance Expense	24,000	
Bad Debt Expense	460	
Unearned Dues Revenue		8,900
Rent Receivable	1,600	
Depreciation Expense—Buildings	4,000	
Depreciation Expense—Equipment	15,000	
Insurance Expense	3,500	
Totals	$839,660	$839,660

*PROBLEM 3-8 (Continued)

(d)

		Debit	Credit
-Dec. 31-			
Dues Revenue		191,100	
Greens Fee Revenue		5,900	
Rental Revenue		19,200	
	Income Summary		216,200
-31-			
Income Summary		184,560	
	Utilities Expense		54,000
	Bad Debt Expense		460
	Salaries Expense		83,600
	Maintenance Expense		24,000
	Depreciation Expense—Buildings		4,000
	Depreciation Expense—Equipment		15,000
	Insurance Expense		3,500
-31-			
Income Summary		31,640	
	Retained Earnings		31,640

*PROBLEM 3-9

(a), (b), (c)

Cash

Bal.	18,500		

Accounts Receivable

Bal.	32,000		

Allow. for Doubtful Accts.

		Bal.	700
		Adj.	1,400
			2,100

Inventory

Bal.	80,000		

Furniture & Equipment

Bal.	84,000		

Accum. Depr.—F. & E.

		Bal.	35,000
		Adj.	12,000
			47,000

Prepaid Insurance

Bal.	5,100	Adj.	2,550
	2,550		

Notes Payable

		Bal.	28,000

Admin. Salaries Expense

Bal.	65,000	Cls.	65,000

Share Capital—Ordinary

		Bal.	80,600

Sales

Cls.	600,000	Bal.	600,000

Insurance Expense

Adj.	2,550	Cls.	2,550

Sales Salaries Expense

Bal.	50,000	Cls.	52,400
Adj.	2,400		
	52,400		52,400

Advertising Expense

Bal.	6,700	Adj.	700
		Cls.	6,000
	6,700		6,700

Interest Expense

Adj.	3,360	Cls.	3,360

Bad Debt Expense

Adj.	1,400	Cls.	1,400

Office Expense

Bal.	5,000	Adj.	1,500
		Cls.	3,500
	5,000		5,000

Prepaid Advertising

Adj.	700		

Interest Payable

		Adj.	3,360

Depr. Exp.—Furn. & Equip.

Adj.	12,000	Cls.	12,000

Income Summary

Exp.	554,210	Sales	600,000
Inc.	45,790		
	600,000		600,000

Office Supplies

Adj.	1,500		

Salaries Payable

		Adj.	2,400

Retained Earnings

		Bal.	10,000
		Inc.	45,790
		Bal.	55,790

Cost of Goods Sold

Bal.	408,000	Cls.	408,000

(b)

-1-

Bad Debt Expense	1,400	
Allowance for Doubtful Accounts		1,400

-2-

Depreciation Expense—Furniture and Equipment ($84,000 ÷ 7)	12,000	
Accum. Depr.—Furniture and Equipment		12,000

-3-

Insurance Expense	2,550	
Prepaid Insurance		2,550

-4-

Interest Expense	3,360	
Interest Payable		3,360

-5-

Sales Salaries Expense	2,400	
Salaries Payable		2,400

-6-

Prepaid Advertising Expense	700	
Advertising Expense		700

-7-

Office Supplies	1,500	
Office Expense		1,500

*PROBLEM 3-9 (Continued)

(c)

	Dec. 31		
Sales		600,000	
Income Summary			600,000

	Dec. 31		
Income Summary		554,210	
Cost of Goods Sold			408,000
Advertising Expense			6,000
Administrative Salaries Expense			65,000
Sales Salaries Expense			52,400
Office Expense			3,500
Insurance Expense			2,550
Bad Debt Expense			1,400
Depreciation Expense—Furniture and Equipment			12,000
Interest Expense			3,360

	Dec. 31		
Income Summary		45,790	
Retained Earnings			45,790

*PROBLEM 3-10

(a)

LAKELAND SALES AND SERVICE
Income Statement
For the Month Ended January 31, 2010

	(1) Cash Basis	(2) Accrual Basis
Revenues	£ 75,000	£98,400*
Expenses		
Cost of computers & printers:		
Purchased and paid	82,500**	
Cost of goods sold		59,500***
Salaries	9,600	12,600
Rent	6,000	2,000
Other operating expenses	8,400	10,400
Total expenses	106,500	84,500
Net income (loss)	£(31,500)	£13,900

*(£2,550 X 30) + (£3,600 X 4) + (£500 X 15)
**(£1,500 X 40) + (£2,500 X 6) + (£300 X 25)
***(£1,500 X 30) + (£2,500 X 4) + (£300 X 15)

*PROBLEM 3-10 (Continued)

(b)

LAKELAND SALES AND SERVICE
Statement of Financial Position
As of January 31, 2010

	(1) Cash Basis	(2) Accrual Basis
Assets		
Cash	£58,500[a]	£ 58,500[a]
Accounts Receivable		23,400
Inventory		23,000[b]
Prepaid rent		4,000
Total assets	£58,500	£108,900
Equity and Liabilities		
Equity	£58,500[c]	£103,900[d]
Salaries payable		3,000
Accounts payable		2,000
Total equity and liabilities	£58,500	£108,900

[a]Original investment	£ 90,000
Cash sales	75,000
Cash purchases	(82,500)
Rent paid	(6,000)
Salaries paid	(9,600)
Other operating expenses	(8,400)
Cash balance Jan. 31	£ 58,500

[b](10 @ £1,500) + (2 @ £2,500) + (10 @ £300).

[c]Initial investment minus net loss: £90,000 – £31,500.

[d]Initial investment plus net income: £90,000 + £13,900.

***PROBLEM 3-10 (Continued)**

(c)

1. **The £23,400 in receivables from customers is an asset and a future cash flow resulting from sales that is ignored. The cash basis understates the amount of revenues and inflow of assets in January from the sale of computers and printers by £23,400.**

2. **The cost of computers and printers sold in January is overstated by £23,000. The unsold computers and printers are an asset of £23,000 in the form of inventory.**

3. **The cash basis ignores £3,000 of the salaries that have been earned by the employees in January and will be paid in February.**

4. **Rent expense on the cash basis is overstated by £4,000 under the cash basis. This prepayment is an asset in the form of two months' future right to the use of office, showroom, and repair space and should appear on the balance sheet.**

5. **Other operating expenses on a cash basis are understated by £2,000 as is the liability for the unpaid portion of these expenses incurred in January.**

*PROBLEM 3-11

(a)

COOKE COMPANY
Worksheet
For the Year Ended September 30, 2010

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	37,400						37,400				37,400	
Supplies	18,600				(b)	14,400	4,200				4,200	
Prepaid Insurance	31,900				(a)	28,000	3,900				3,900	
Land	80,000						80,000				80,000	
Equipment	120,000						120,000				120,000	
Accum. Depreciation		36,200			(c)	5,800		42,000				42,000
Accounts Payable		14,600						14,600				14,600
Unearned Ad. Rev.		2,700	(d)	2,000				700				700
Mortgage Payable		50,000						50,000				50,000
Cooke, Capital		109,700						109,700				109,700
Cooke, Drawing	14,000						14,000				14,000	
Admissions Revenue		278,500			(d)	2,000		280,500		280,500		
Salaries Expense	109,000						109,000		109,000			
Repair Expense	30,500						30,500		30,500			
Advertising Expense	9,400						9,400		9,400			
Utilities Expense	16,900						16,900		16,900			
Prop. Taxes Expense	18,000		(e)	3,000			21,000		21,000			
Interest Expense	6,000		(f)	6,000			12,000		12,000			
Totals	491,700	491,700										
Insurance Expense			(a)	28,000			28,000		28,000			
Supplies Expense			(b)	14,400			14,400		14,400			
Interest Payable					(f)	6,000		6,000				6,000
Depreciation Expense			(c)	5,800			5,800		5,800			
Prop. Taxes Payable					(e)	3,000		3,000				3,000
Totals				59,200		59,200	506,500	506,500	247,000	280,500	259,500	226,000
Net Income									33,500			33,500
Totals									280,500	280,500	259,500	259,500

Key: (a) Expired Insurance; (b) Supplies Used; (c) Depreciation Expensed; (d) Admission Revenue Earned; (e) Accrued Property Taxes; (f) Accrued Interest Payable.

(b)

COOKE COMPANY
Statement of Financial Position
September 30, 2010

Assets			
Noncurrent assets			
Property, plant, and equipment			
Land		$80,000	
Equipment	$120,000		
Less: Accum. depreciation	42,000	78,000	$158,000
Current assets			
Supplies		4,200	
Prepaid insurance		3,900	
Cash		37,400	
Total current assets			45,500
Total assets			$203,500
Equity and Liabilities			
Equity			
Cooke, Capital ($109,700 + $33,500 – $14,000)			$129,200
Liabilities			
Mortgage payable		$40,000	
Current liabilities			
Accounts payable	$14,600		
Current maturity of long-term debt	10,000		
Interest payable	6,000		
Property taxes payable	3,000		
Unearned admissions revenue	700		
Total current liabilities		34,300	
Total liabilities			74,300
Total equity and liabilities			$203,500

*PROBLEM 3-11 (Continued)

(c)	Sep.	30	Insurance Expense	28,000	
			Prepaid Insurance		28,000
		30	Supplies Expense	14,400	
			Supplies		14,400
		30	Depreciation Expense	5,800	
			Accum. Depreciation		5,800
		30	Unearned Admissions Revenue	2,000	
			Admissions Revenue		2,000
		30	Property Taxes Expense	3,000	
			Property Taxes Payable		3,000
		30	Interest Expense	6,000	
			Interest Payable		6,000
(d)	Sep.	30	Admissions Revenue	280,500	
			Income Summary		280,500
		30	Income Summary	247,000	
			Salaries Expense		109,000
			Repair Expense		30,500
			Insurance Expense		28,000
			Property Taxes Expense		21,000
			Supplies Expense		14,400
			Utilities Expense		16,900
			Interest Expense		12,000
			Advertising Expense		9,400
			Depreciation Expense		5,800

30	Income Summary	33,500	
	Cooke, Capital		33,500
30	Cooke, Capital	14,000	
	Cooke, Drawing		14,000

(e)

COOKE COMPANY
Post-Closing Trial Balance
September 30, 2010

	Debit	Credit
Cash	$ 37,400	
Supplies	4,200	
Prepaid Insurance	3,900	
Land	80,000	
Equipment	120,000	
Accumulated Depreciation		$ 42,000
Accounts Payable		14,600
Unearned Admissions Revenue		700
Interest Payable		6,000
Property Taxes Payable		3,000
Mortgage Payable		50,000
Cooke, Capital		129,200
	$245,500	$245,500

FINANCIAL REPORTING PROBLEM

(a) March 29, 2008 total assets: £7,161 million.
March 31, 2007 total assets: £5,381 million.

(b) March 29, 2008 cash and cash equivalents: £318 million.

(c) 2008 selling and marketing expenses: £1,912.7 million.
2007 selling and marketing expenses: £1,779.2 million.

(d) 2008 revenues: £9,022.0 million.
2007 revenues: £8,588.1 million.

(e) An adjusting entry for deferrals is necessary when the receipt/disbursement precedes the recognition in the financial statements. Accounts such as prepaid pension contributions and prepaid leasehold premiums are included in the Trade and other receivables section (£410.0 million at March 29, 2008). Both of these accounts would require an adjusting entry to recognize the proper amount of expense incurred during the period. In addition, depreciation expense is an adjusting entry related to a deferral.

An adjusting entry for an accrual is necessary when recognition in the financial statements precedes the cash receipt/disbursement, such as interest or taxes payable. Other adjusting entries probably made by M&S include finance income and finance costs and bank and other interest receivable and interest payable.

(f) 2007 Depreciation and amortization expense: £282.7 million
2008 Depreciation and amortization expense: £317.6 million

COMPARATIVE ANALYSIS CASE

(a) Cadbury's percentage decrease is computed as follows:

Total assets (December 31, 2008)	**£ 8,895**
Total assets (December 31, 2007)	**(£11,338)**
Difference	**£ (2,443)**

£(2,443) ÷ £11,338 = (21.5)%

Nestle's percentage decrease is computed as follows:

Total assets (December 31, 2008)	**CHF 106,215**
Total assets (December 31, 2007)	**(115,361)**
Difference	**CHF (9,146)**

(9,146) ÷ 115,361 = (7.9)%

Cadbury suffered the larger decrease.

(b) Cadbury reported an £84 million profit from discontinued operations, which represented almost 21% of its profit from continuing operations. Reporting a discontinued operations this large may make comparisons between companies difficult. Since discontinued operations are considered to be nonrecurring, they should be excluded before comparing results between the two companies.

COMPARATIVE ANALYSIS CASE (Continued)

(c) Cadbury had depreciation and amortization expense of £244 million (52% of operating cash flow); Nestle had depreciation and amortization expense of 3,249 CHF million (30% of operating cash flow).

Nestle has substantially more property, plant, and equipment and intangible assets than does Cadbury. Amortizable intangible assets for Cadbury and Nestle increase the amount of amortization expense recorded in income. The amount of property, plant, and equipment and amortizable intangible assets reported for these two companies is as follows:

	Cadbury	Nestle
Property, plant, and equipment (net)	£1,761,000,000	£21,097,000,000
Amortizable intangible assets (net)	1,685,000,000	6,867,000,000
	£3,446,000,000	£27,964,000,000

FINANCIAL STATEMENT ANALYSIS CASE

Vodafone

(a)

Vodafone Group plc	2009	2008	2007	% Change 2009	% Change 2008
Revenues	£ 41,017	£ 35,478	£ 31,104	15.61%	14.06%
Gross Profit %	37.00%	38.30%	39.80%	–3.39%	–3.77%
Operating Profit	£ 5,857	£ 10,047	(£ 1,564)	–41.70%	–742.39%
Operating Cash Flow less Capital Expenditures	7,009	6,622	6,695	5.84%	–1.09%
Profit (Loss)	3,080	6,756	(5,222)	–54.41%	–229.38%

(b) Except for an increase in Revenues, Vodafone's earnings performance has been declining; gross profit, operating profit, and net income (profit) have declined in 2009. Note that 2007 was a very poor year; but after some improvement in 2008, things have turned a bit to the negative. One promising development is the cash flow measure, which is on the increase. So while Vodafone may be able to deliver on its free-cash-flow generation objective, the earnings performance does not give a good signal that Vodafone has been or will be able to deliver on operating performance and growth opportunities.

ACCOUNTING ANALYSIS, AND PRINCIPLES

ACCOUNTING

Depreciation Expense	9,500	
Accumulated Depreciation—Equipment		9,500

$9,500 = ($192,000 – $40,000) ÷ 16

Interest Expense	8,250	
Interest Payable		8,250

$8,250 = ($90,000 X 0.10) X 11/12

Unearned Ticket Revenue	10,000	
Ticket Revenue		10,000

$10,000 = ($50 X 200)

Advertising Expense	2,500	
Prepaid Advertising		2,500
Salaries Expense	3,500	
Salaries Payable		3,500

ANALYSIS

	Income before Adjustments	Adjustments	Income after Adjustments
Ticket revenue	£360,000	£10,000	£370,000
Depreciation expense		(9,500)	(9,500)
Advertising expense	(18,680)	(2,500)	(21,180)
Salaries expense	(67,600)	(3,500)	(71,100)
Interest expense	(1,400)	(8,250)	(9,650)
Net income	£272,320		£258,570

Without recording the adjusting entries, Amato's income is overstated. In addition, without the adjustments, Amato's current liabilities and current assets are misstated, which could affect evaluation of Amato's liquidity.

ACCOUNTING ANALYSIS PRICIPLES (Continued)

PRINCIPLES

The tradeoffs are between the timeliness of the reports, which contributes to relevance, and verifiability, the lack of which detracts from faithful representation. That is, by preparing reports more frequently, the company provides more timely information, which can make a difference to a statement reader who needs to make a decision. However, preparing statements more frequently requires more subjective estimates, which reduces faithful representation.

PROFESSIONAL RESEARCH

(a) Assets

53 The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

54 An entity usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.

55 The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

a. used singly or in combination with other assets in the production of goods or services to be sold by the entity;
b. exchanged for other assets;
c. used to settle a liability; or
d. distributed to the owners of the entity.

(b) Liabilities

60 An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

61 A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

62 The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

a. payment of cash;
b. transfer of other assets;
c. provision of services;
d. replacement of that obligation with another obligation; or
e. conversion of the obligation to equity.

(c) Accrual basis

22 In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

PROFESSIONAL SIMULATION

Journal Entries

Dec. 31	Accounts Receivable	1,500	
	Advertising Revenue		1,500
31	Unearned Advertising Revenue	1,400	
	Advertising Revenue		1,400
31	Art Supplies Expense	3,400	
	Art Supplies		3,400
31	Depreciation Expense	7,000	
	Accumulated Depreciation		7,000
31	Salaries Expense	1,300	
	Salaries Payable		1,300

Financial Statements

Nalezny Advertising Agency
Income Statement
For the Year Ended December 31, 2010

Revenues		
Advertising revenue		$61,500
Expenses		
Salaries expense	$11,300	
Depreciation expense	7,000	
Rent expense	4,000	
Art supplies expense	3,400	
Total expenses		25,700
Net income		$35,800

PROFESSIONAL SIMULATION (Continued)

Nalezny Advertising Agency
Statement of Financial Position
December 31, 2010

Assets

Printing equipment	$60,000	
Less: Accumulated depreciation— printing equipment	35,000	$25,000
Art supplies		5,000
Accounts receivable		21,500
Cash		11,000
Total Assets		$62,500

Equity and Liabilities

Equity		
Share capital—ordinary	$10,000	
Retained earnings		$50,600
	40,600*	
Liabilities		
Accounts payable	5,000	
Unearned advertising revenue	5,600	
Salaries payable	1,300	
Total liabilities		11,900
Total equity and liabilities		$62,500

*Retained earnings, Jan. 1, 2010	$ 4,800
Add: Net income	35,800
Retained earnings, Dec. 31, 2010	$40,600

Explanation

Following preparation of financial statements (see Illustration 3-6), Nalezny would prepare closing entries to reduce the temporary accounts to zero. Some companies prepare a post-closing trial balance and reversing entries.